H.R. 219—HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1997

HEARING

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

APRIL 23, 1998

Printed for the use of the Committee on Banking and Financial Services

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HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES

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H.R. 219—HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1997

THURSDAY, APRIL 23, 1998

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The committee met, pursuant to call, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach, [chairman of the committee], presiding.

Present: Chairman Leach; Representatives McCollum, Roukema, Lazio, Kelly, Weldon, Cook, Hill, LaFalce, Vento, Kanjorski, Kennedy, C. Maloney of New York, Roybal-Allard, Barrett, Watt, Bentsen, Kilpatrick, J. Maloney of Connecticut, Hooley, Weygand, and Sherman.

Chairman LEACH. The hearing will come to order.

The committee meets today to hear testimony on H.R. 219, the Homeowners' Insurance Availability Act of 1997, which was introduced by Housing Subcommittee Chairman Rick Lazio. The Housing Subcommittee reported the bill on February 4, 1998, with bipartisan support.

The legislation, along with that of a similar proposal of Committee Vice Chairman Bill McCollum, highlights a growing problem in some States where homeowners' insurance has become difficult, if not impossible, to obtain at affordable rates.

For example, after the 1994 Northridge Earthquake in California, 95 percent of the homeowners' insurance markets shut down. In 1992, Hurricane Andrew in Southeast Florida cost $33 billion and, according to the Florida Department of Insurance, created an environment where cancellations of homeowners' policies and retreat from the State by insurance companies were at hand.

Moreover, a 1996 study indicated that the number of insurance underwriters dropped within the last ten years by 31 percent in Florida, 29 percent in Texas, 23 percent in California and 15 percent in Pennsylvania. These conditions precipitated the creation of State insurance programs to meet the gap between homeowners' and participating insurers. Despite withdrawals from the insurance market, the property casualty industry nearly doubled its capital and surplus since 1992 and experienced record market profits in 1997.

While there may be competing philosophical views regarding the nature and role of the Federal Government, all parties would agree that the problem of insurance availability in disaster-prone areas is real and is worthy of congressional attention.

Traditionally, the issue of natural disaster assistance has been under the purview of another committee that primarily focused on the Stafford Disaster Assistance Act, mitigation of natural hazards through building and zoning code enforcement, as well as Federal incentives to expand capital in the reinsurance capital markets.

The Banking Committee's interest centers on the fundamental question of whether there is an appropriate Federal role in intervention in capital markets to ensure the availability and affordability of homeowners' insurance in disaster-prone areas, while at the same time meeting actuarial standards that avoid the creation of imprudential Federal contingent liabilities.

The Housing Subcommittee held two hearings on this issue, and Mr. Lazio, Mr. McCollum and I have had many conversations with both Secretary Rubin and Secretary Summers, who have committed to working with the committee in perfecting the legislation before we move to a full committee markup.

In addition to Mr. Summers, a broad spectrum of witnesses representing every sector and voice interested in this legislation will be before us today. I am hopeful that following this hearing, the committee will produce a bill that ensures an open market for homeowners' insurance while at the same time protecting the Federal Government from unreasonable financial exposure. I believe the subcommittee reported bill is a viable foundation and worthy of the full committee's consideration.

[The prepared statement of Hon. James A. Leach can be found on page 114 in the appendix.]

Mr. LaFalce, the Democratic Ranking Member, is recognized for opening remarks.

Mr. LAFALCE. Thank you very much, Mr. Chairman. I am very, very pleased that you are bringing this important issue to the attention of the full committee. I believe the Federal Government could play an appropriate role in helping consumers access affordable disaster insurance, but when the Federal Government should be involved in an effort and how the Federal Government should be involved are key questions we need to really deliberate about.

I am concerned, though, that few Members might have the time to sit through five panels, and that is what we have before us today. As for those who are able to stay for the duration of five panels, I am concerned that they might hear repetitive answers from a number of the witnesses today. I am not sure the panels are as balanced as they could be.

For example, I would like to hear from some official from the State of New York or another State that has conducted studies of the market of disaster insurance and made a determination that creation of a specialized pool to diversify risk is unnecessary. I think that perspective might have been helpful. And I would also like to have heard from witnesses from Consumers Union and the Consumer Law Center who have also studied this issue.

The only consumer witness, I believe, who is appearing today is on the fifth panel, and I don't know how many Members we will have at that time. Key witnesses who can explain private market alternatives to the approach taken in the nature of H.R. 219, Mr. Nutter of the reinsurance industry and Mr. Lewis of Ernst & Young, will not be appearing until the fourth panel.

Having said that, I do want to say how much I look forward to hearing from all the witnesses and then especially the Treasury Department today. They have given considerable thought to the appropriate Federal role in providing disaster insurance, and I agree with much of their written testimony. The committee should be looking very closely at how we can support the existing disaster insurance market, including the reinsurance industry, in capital markets.

Whatever we do, we must take every precaution not to replace the existing market participants, and instead we must determine how we can foster growth within the market. In addition, we must sunset the Federal program when the private market can cover the losses associated with the 1-in-100 year event. In addition, we must determine how we may inject the Federal Government in the market without exposing a national risk and the undue risk of loss.

I also look forward to the testimony at the end of the day from the Consumer Federation of America, which can assist us in developing a Federal program that guarantees that more consumers will have access to affordable disaster insurance. Likewise, I am interested in whether the Federation believes the bill goes far enough in directing States to set aside funds for mitigation programs.

Mr. Chairman, again I want to thank you very much for convening this hearing to help shed light on this very important topic, and I look forward to hearing from all the distinguished witnesses before us. Thank you.

Chairman LEACH. Thank you, Mr. LaFalce.

Mr. McCollum.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman. I want to thank you for holding this hearing today, as well, and I want to compliment my good friend Mr. Lazio for bringing this bill forward, H.R. 219, today. I, as you may know, introduced a companion bill, H.R. 230, and have sponsored Mr. Lazio's bill as well.

The bottom line is we do have 1-in-100 year events that occur in catastrophic cases involving hurricanes, earthquakes and so forth, and we have no way of dealing with that in terms of the insurance structure of the Nation. Reinsurance, while available on a limited basis, is not there for the companies that have exposure for these catastrophic events. You just simply can't buy it today. And not having reinsurance for very large losses that are potentially out there is driving up the cost of homeowners' insurance policies in my State and elsewhere.

In addition to that, there is a question of whether or not there will be sufficient available insurance in States like California, Florida, and many others that are exposed to these kinds of large events. If at some point in time a couple of these storms come through or the big earthquake, the big banana, hits that never has up the middle of the country through Missouri and Illinois and so forth, insurers are exposed to enormous risks and may well go further than they have already in attempting to remove themselves from those markets.

So I think it is very important there be a reinsurance market. The private industry ideally would be providing that, and I agree with Mr. LaFalce that we ought to get to the point some day where we do have everything in the private market again. But for right

now, what this hearing is about today is to help us, I think, find a method of dealing with how we go through the process of providing in the interim the reinsurance that is not there.

The primary purpose of the bill that is before us today is to back up State catastrophic funds while introducing an auction component on a State-by-State basis. The question is, in part, whether the framework of the bill today that we are hearing is the exact right mix. Will the insurers fully participate in the auction market that is envisioned in those States which will conduct an auction market? Does there need to be an opportunity for a State where there is a catastrophic fund, more fully than perhaps is in the bill, or in some alternative way to provide auction opportunities for insurance companies themselves to buy in those States of Florida, Hawaii and California that already have the catastrophic funds? Are the excess-of-loss contracts appropriate? Will the trigger mechanisms be at the right level, what is the right level to trigger the payout of monies, and are there problems with the caps that we place on the amount of money the Federal Government would be supporting in terms of the losses above a certain trigger point?

This is not a simple matter in terms of technically how you do this, and I again commend Mr. Lazio and his subcommittee for bringing forth a product to try to get to this point today. And I hope today, Mr. Chairman, the witnesses we have will help us sort out the problems with the current legislative proposal, ways we can improve it, but most of all give us the insight into how we can move, finally, a bill that provides a final product to the desk of the President for signature for this Congress that will give us the relief that is necessary in the reinsurance market for homeowners' catastrophic events, such as windstorm and so forth.

While I have the microphone, I would like to acknowledge the fact that three Floridians will be testifying at one point or another: Donald Dowdell, the Deputy General Counsel for the Department of Insurance from Florida; Rade Musulin of the Florida Farm Bureau Insurance Company; and Cathy Whatley on behalf of the National Association of Realtors.

Mr. Chairman, I imagine this being submitted and admitted without a need for this, but I would like to ask unanimous consent for the statement of the American Insurance Association that is not appearing before us today, but they have asked their statement be admitted into the record, and I would like to ask it be done.

[The statement referred to can be found on page 254 in the appendix.]

Chairman LEACH. Without objection.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Chairman LEACH. Thank you for that very thoughtful statement. Yes, please, go right ahead.

Ms. ROYBAL-ALLARD. First of all, let me begin by commending the Chairman for holding this very timely and important hearing. It is certainly an issue that is extremely important to the State of California. And I would like to give a special acknowledgment to my California colleague, Mr. Fazio, who has really been a leader on the issue of disaster insurance, as well as to recognize Ms. Heimbuch, representing the Western League of Savings Institu-

tions, and David Knowles, California's Chief Deputy Insurance Commissioner, who will be testifying later.

Their attendance reinforces the critical need for Congress to address the issue of affordable and accessible disaster relief insurance in this country. In my home State of California, the Whittier, Loma Prieta and Northridge Earthquake caused billions of dollars of damage to uninsured property and many uninsured homeowners were unable to pay for the damages, especially the uninsured victims of the Northridge Earthquake. These borrowers were forced to abandon their homes, resulting in severe losses to lending institutions such as those belonging to the Western League of Savings, who were forced to foreclose on these abandoned homes.

These earthquakes also caused billions of dollars of damage to insured property. These losses had a profound effect on our State's insurance market, and subsequently the availability of earthquake insurance to homeowners.

In the wake of the Northridge Earthquake, California passed legislation that required insurance companies to offer earthquake insurance with their homeowners' insurance policy. The result was that many companies simply stopped selling homeowners' insurance to avoid losses that may be caused by future earthquakes.

In order to fill the void left by the insurance companies' departure, the State created the California Earthquake Authority. While this agency increased the availability of earthquake coverage, many of our State's residents are still unable to afford the exorbitant premiums and the high deductibles that are offered by the CEA.

As we in California know, Congress must act to make disaster relief insurance both more affordable as well as accessible. I commend Mr. Lazio and Mr. Fazio for working so diligently to address this great problem. However, my chief concern in creating a Federal reinsurance program is that the risk and costs are not shifted to the Nation's families.

Any piece of legislation should ensure that homeowners, including low- and moderate-income families, have access to affordable coverage. Federal policy should also ensure that all parties involved take a proactive approach to minimizing the effects of disasters before they occur. Therefore, strong pre-disaster mitigation measures should be included in any Federal legislation that Congress ultimately approves.

And, finally, it is critical that we not only meet the needs of our residents, lenders and insurers, but that we find the appropriate balance for the involvement of the Federal Government.

I feel confident that this committee, working in cooperation with the panelists and the consumer groups, will craft effective and meaningful legislation. I look forward to hearing from the panelists, and once again, Mr. Chairman, I would like to thank you for holding this hearing.

Chairman LEACH. Thank you, Ms. Roybal-Allard.

Mr. Lazio, the distinguished introducer of this legislation.

Mr. LAZIO. Thank you, Mr. Chairman. Let me begin by thanking you for your continued and sustained support for our efforts to provide homeowner insurance availability to some of the more vulner-

able areas of our Nation. I know without your support we would not be at the point of considering a legislative solution this year.

I also want to thank my good friend and colleague, Bill McCollum, for his work and dedication to the issues surrounding this legislation and, in general, natural disasters. Certainly his continued support has been critical in bringing this to the point where we are discussing some of the solutions today.

The Homeowners' Insurance Availability Act of 1997, H.R. 219, is a bipartisan culmination of years of debate among the Congress, the Administration, the insurance industry and consumer groups on how best to provide protection for homeowners living in areas at risk of earthquakes and hurricanes. I also want to note that Mr. Fazio of California has been an ally and partner throughout this process, and the technical support, certainly over the last couple months, of Mr. Summers, and the support of Mr. Rubin has helped us arrive at this point.

The first half of the 1990's left parts of the country devastated by natural disasters causing more than $30 billion in insured losses in California and Florida alone. During that time, the Federal Government spent more than $50 billion in natural disaster assistance across the country. Obviously not all of that would be mitigated with the approach contained in H.R. 219.

Testimony before the Housing Committee in this Congress warned that the East and Gulf Coasts of the United States are entering a prolonged period of more frequent and more destructive hurricane activity. Within the next ten years, almost 75 percent of our population will be living within 100 miles of a United States coastline. Experts are predicting it may only be a matter of time before a single storm causes $50 billion in damages.

In this environment we find evidence of insufficient capacity to provide insurance to homeowners in these affected areas. Families living on both coasts, from New York to Washington State, and families living in earthquake-prone regions from Tennessee to Missouri, are facing the same problem. Many are finding it difficult, if not impossible, to obtain adequate insurance protection for their homes. We must ask ourselves one simple question: Should we wait unprepared for the inevitable and throw a crisis-driven solution in the wake of some massive catastrophe, or should we plan for our future now?

Our proposal recognizes that there is indeed a potential crisis of homeowners' insurance availability in affected areas across the country. It recognizes that currently the private market is unable to provide the kind of protection consumers need in some of the country's most vulnerable areas.

Should any solution at the Federal level be a surgical strike targeted to encourage and complement the existing industries? Absolutely. Should any Federal solution be temporary in nature, without intruding upon the private sector? Yes. Does our proposal strike an appropriate balance between the need for greater protection for homeowners and the belief that the most efficient and most effective solutions in the end reside in the private market? Yes, I believe it does.

But as we move forward, we should be careful to remember that our proposal is at heart not about the capital markets or the insur-

ance industry. It is about unprotected families who without some relief risk losing what is oftentimes their greatest investment, their homes.

Washington cannot and should not solve the problem directly. Insurance is best regulated at the State level where the unique needs of communities are better understood. Our proposal honors this principle. Where the industry and States are unable to absorb the very low-probability, high-cost disasters, the Federal Government has an appropriate role to play. And let me be clear: Under this proposal, qualified State programs and insurance companies that do business in those States must absorb 99 percent of the risk before Federal reinsurance would be forthcoming.

In fact, this legislation as presently drafted would not have been triggered by either Hurricane Andrew or the California Northridge Earthquake because of the growing capacity of those two funds. But by providing an umbrella of Federal protection against the mega-catastrophe, our legislation gives the industry some assurances of continued solvency, thereby providing insurance companies greater ability and encouragement to protect against lower level risks.

Mr. Chairman, I am hopeful that with your support and the continued input of the Administration, we will be able to move forward with legislation in the weeks to come before the beginning of the hurricane season. The worst case scenario would be to wait for the inevitable catastrophe to hit before we react, without having done our due diligence and having prepared ourselves, and having a structure in place to provide piece of mind both to the homeowners, most importantly, and also a comfort level to insurance companies to assure liquidity.

Let me again thank you for holding this hearing, and I look forward to today's testimony.

Chairman LEACH. Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman. I will be brief because I would like to get to the witnesses.

There are two assumptions that generally get made that I want to talk about in this context. Most people view me as the raving liberal, but on the Judiciary Committee I am actually known as the States' rights advocate, and I think more and more people are coming to learn that I am a strong believer in the market.

Notwithstanding those two things, however, it has long been my belief that one of the areas that the Federal Government has an important role in is this area that we are least able to contemplate as the private insurers when acts of God occur, although insurance, I am sure, is about risk, is to some extent about assessment of risk that can be contemplated.

So I believe there is a role for the Federal Government in this area. I am not sure that this is the bill or not, because I am not on the subcommittee that marked it up and I am not familiar with the provisions of the bill. But it is for that reason that I want to applaud the Chairman for conducting this hearing to give all of the Members of the Banking Committee the opportunity to understand more about this bill, and whether this is the particular bill that we should lobby behind or whether there is some other bill that might be more appropriate.

In that context, I am looking forward to hearing the testimony and getting to understand more about this bill and the arguments on both sides of this issue, so that we can try to address a problem that I think is incumbent on the Federal Government to address, because we are a United States and various different areas of the country can get hit without being able to contemplate the kinds of disasters that we are here to talk about.

So I want to thank the Chairman for the hearing, and I yield back the balance of my time.

Chairman LEACH. Thank you very much, Mr. Watt.

Mrs. Kelly, would you like to make an opening statement? You are recognized.

Mrs. KELLY. Thank you, Mr. Chairman. I would like to thank you, Chairman Leach, and Ranking Member LaFalce for calling today's hearing on disaster insurance.

As a Member of the Subcommittee on Housing, I am familiar with the need for the Federal Government to step in at some high level of catastrophe when the private sector has reached its limit. Of course, that begs the question, what is that number, the limits of the private sector coverage.

Today we have H.R. 219 before us. There are some real merits to the approach of H.R. 219 which I am sure we will explore in detail. We will also continue to take a very close look at and incorporate parts of my friend Mr. McCollum's legislation on the same issue, H.R. 230. Mr. McCollum's approach has a great deal of merit, and I hope that today we can continue to explore these ideas to make improvements to H.R. 219.

While disaster insurance is certainly a national issue we need to work on, I can't help always coming back to how this legislation would affect New York homeowners. In the past few months I have had some conversations with different New Yorkers and agencies to better understand their views. As Mr. LaFalce said, there are a number of agencies in New York that have done some studies. And to share these views with the committee, I ask unanimous consent to have the Temporary Panel on Homeowners' Insurance Coverage report to Governor Pataki dated February 1, 1998, made a part of the record.

[The information referred to can be found on page 151 in the appendix.]

Chairman LEACH. Without objection, so ordered.

Mrs. KELLY. Thank you, Mr. Chairman.

I also ask unanimous consent to have a Study of Market Dynamics and Homeowners' Insurance Policy dated February 15, 1998, authored by the New York State Insurance Department, made a part of the record.

[The information referred to can be found on page 118 in the appendix.]

Chairman LEACH. Without objection, so ordered.

Mrs. KELLY. Thank you.

These two reports have some very compelling conclusions, one being, the availability of homeowners' insurance in New York City, Westchester County and Long Island, including shoreline communities, has improved in the last two years. The conclusions of these

very recent reports certainly have my attention, and I look forward to exploring these with our witnesses.

I want to thank all of the witnesses for joining us here today to share their views with us, and look forward to continuing to work with all of my colleagues from both sides of the aisle as we look to make improvements to this legislation. Thank you very much, and I yield back the balance of my time.

Chairman LEACH. Well, thank you, Mrs. Kelly.

Ms. Hooley.

Ms. HOOLEY. Thank you, Mr. Chairman. I ask consent to enter my full statement into the record, and I will be very brief.

Chairman LEACH. Without objection, so ordered.

Ms. HOOLEY. First of all, I would like to start by stating my strong support for passing some kind of Federal legislation to increase the availability of homeowners' insurance in the United States. I represent an area in Oregon that is prone to natural disasters, and certainly have a great interest in passing a bill that would increase that accessibility and affordability for homeowners. I appreciate the willingness of the Chair to work with me to resolve a problem in my State, particularly by considering the inclusion of volcanic disasters as a peril covered by this legislation.

I am aware that staff has been working with me on a reasonable solution, and I am hopeful the committee will decide to include coverage for volcanic disasters in the final version of the legislation. I look forward to continuing the conversation as we move closer to markup.

Today, however, I am anxious to hear from our distinguished witnesses as we proceed with a thorough examination of this legislation. While I have cautiously supported this legislation at this point, I intend to keep an open mind as we continue to work on a bill that is truly beneficial for Oregonians and all citizens who live in disaster-prone areas.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Darlene Hooley can be found on page 117 in the appendix.]

Chairman LEACH. Thank you, Ms. Hooley.

Mr. Cook, do you have an opening statement?

Mr. COOK. No, thank you, Mr. Chairman.

Chairman LEACH. Thank you.

Ms. Kilpatrick.

Ms. KILPATRICK. Mr. Chairman, I would like permission to submit my written statement for the record.

Chairman LEACH. Without objection.

There being no other committee Members who have opening statements, I would like to invite the first panel to come to the table.

By way of introduction, first let me welcome you all. Mr. Fazio has long been involved in the efforts to reduce the costs of natural disasters and protect families at risk, and along with Mr. Lazio and Mr. McCollum, Mr. Fazio is an original cosponsor of the legislation under consideration today, and we welcome you.

Representative Jo Ann Emerson has continued the efforts of her late husband to bring greater attention to the need for more affordable and more available homeowners' insurance for families who

live in disaster-prone areas, and also is a cosponsor of the legislation before us, and we welcome you, Jo Ann.

Mrs. EMERSON. Thank you.

Chairman LEACH. Congresswoman Christian-Green has also been a very strong advocate of affordable disaster insurance, and next to the State of Iowa, she is representing one of the more beautiful States in the country. And your appearance before us is welcome. I think it is probably the first for several of you, and we welcome you before our committee.

Vic, as a long time friend and colleague, as our senior Member present, why don't you begin?

STATEMENT OF HON. VIC FAZIO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. FAZIO. Thank you, Mr. Chairman. I want to thank you and Mr. LaFalce and the other Members of the committee for holding this hearing on H.R. 219, the Homeowners' Insurance Availability Act, and as I look at the list of Members of this panel, it is pretty evident that this committee has made a very serious commitment to focus on the issues of natural disasters by involving representatives from the Administration, several States, and affected industries.

I particularly want to pay a tribute to Rick Lazio and to Bill McCollum, who have really worked with us to make this a bipartisan bill. It isn't obviously anything but a regional bill in the minds of some people. I think it is truly a national bill, one that really needs to be looked at by all Members as an important contribution to the public safety of the citizens of this Nation.

It really means a lot to me to be here with Jo Ann because I inherited my cosponsorship from Norm Mineta and Bill Emerson, who took the lead on this over a number of years. And I have been to Donna Christian-Green's district and I have seen the devastation that hurricanes bring, and it is appropriate that we have a cross-section of people here at this time.

The most earthquake-prone regions of the country are not just California, but as Darlene said, the Northwest, and as Jo Ann's presence indicates, the Tennessee Valley. We have a tremendous potential threat all across the country.

I want to acknowledge and thank Deputy Treasury Secretary Larry Summers for his willingness to engage in an open-ended dialogue with the Congress and the industry as well. The Administration faces the challenge of dealing with many complex issues relating to natural disasters. Dealing with extreme financial challenges that come with each crisis is one of the most critical. Deputy Secretary Summers has honored this responsibility throughout these discussions, and I know that the minute details of the legislation will continue to be refined here today and in the future.

But I would like to offer my support for a Federal insurance backstop for natural disasters from a more specific point of view, and that is as a Member from a district in northern California. Our State has experienced more than its fair share of disasters. The Northridge and Loma Prieta earthquakes are of recent memory. The floods that have ravaged my district in 1995 and 1997 are just

a few. This year's El Nino season has brought southern California a significant hit as well.

And although this bill would not deal specifically with floods, its attention to providing homeowners access to affordable insurance so that they are covered in the event of hurricanes and earthquakes is a positive first step toward addressing the enormous problem of dealing with natural disasters, disasters that, as recent tragic events in Alabama, Georgia and Tennessee have shown us, have become an increasingly harsh reality.

By law, insurance companies in California also are required to offer earthquake insurance. After paying for the huge number of claims that resulted from the Northridge Earthquake in 1994, insurers became increasingly concerned that another earthquake would exhaust their available resources. This concern has prompted many companies to stop selling homeowners' insurance. Many began notifying existing policyholders their insurance would not be renewed. The situation in our State was mirrored in other States with a high occurrence of natural disasters.

In disaster-prone areas throughout the country, 93 percent of companies that write homeowners' insurance have stopped selling new policies because of the risk of insolvency in their areas. Far too often those who are affected the most by this retreat of insurers are residents in the most at-risk communities who have lost access to homeowners' insurance for disasters.

The California Earthquake Authority was created by our legislature in 1996 to resolve the crisis. It represents an effective partnership between the State government and the private sector. It is administered by a five-person board comprised of elected officials. The funds available to pay claims come from premiums paid to insurance companies and reinsurance purchased by the CEA. No public money, including funds from the State's general fund, is pledged to cover losses incurred by the CEA policyholders.

Their policies are sold through private insurance agents, and policyholders must purchase earthquake insurance from the company that carries their regular property insurance. The CEA has a $10 billion claims-paying capacity. However, if we experience a disaster and residential damage exceeds $10 billion, consumer claims could not be paid in full and residents would receive pennies on the dollar.

State and Federal funds have been a traditional source of help for public agencies and individuals after earthquakes and other disasters. Over the last several years, as I am sure the committee knows, the Federal Government spent more than $50 billion in natural disaster assistance. We can do a lot better by enabling States such as mine, that have set up a mechanism to address this problem, to purchase reinsurance contracts from the Federal Government.

In the event of a disaster exceeding the CEA's claim-paying capacity, the Federal backstop will prevent an enormous amount of funds from being expended from the general treasury. But I don't want to overemphasize that because, more importantly, it will ensure that homeowners' claims will be paid in full while promoting insurers to renew offering policies in high-risk areas and encourag-

ing consumers to take steps to protect themselves by purchasing them.

Mr. Chairman, I will stop at this point because there is a lot more to be said, but I think the proactive approach of the Federal Government here in the long run will not only save us money but will do a great deal to serve the public interest that we are elected to provide for.

I think the committee is clearly serious about this issue. I know it is complex, I know there have been at least superficially some divisions in the ranks, but I think this committee is capable of putting together a consensus bill that will spread the coverage across the country as States step up to the plate first themselves. I think it is a shared responsibility, and one I am happy to see this committee is willing to take up.

Chairman LEACH. Thank you, Mr. Fazio.

Mrs. Emerson.

STATEMENT OF HON. JO ANN EMERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mrs. EMERSON. Thank you, Mr. Chairman. Thank you for holding this hearing today. I am pleased to have the opportunity to follow-up on the previous testimony I gave before the Housing and Community Opportunities Subcommittee regarding H.R. 219.

As I indicated to Members of that subcommittee, I am by no means a policy expert on the different proposals that have been introduced to address the decreasing availability of homeowners' insurance in disaster-prone areas. However, as a representative of a district that is highly disaster-prone, I am very much aware of the impact that disasters have on this country, its citizens and the communities, both large and small, in which they strike.

Missouri's 8th Congressional District faces a number of different natural disaster threats. The flood-prone Mississippi River comprises the entire eastern boundary of my 26-county district. A string of tornadoes recently ravaged close-lying neighborhood communities in southern Illinois, Tennessee and Arkansas. And perhaps most frightening of all, the entire east side of the district is located along an earthquake fault known as the New Madrid fault.

During the winter of 1811 to 1812, an earthquake along this fault with aftershocks ranging between 8.0 and 8.6 devastated a very large region of the United States. Fortunately, at that time there were very few communities in the area and the loss of life was relatively low. Today, however, the area is populated with major urban areas like Memphis to the south and St. Louis to the north.

The scary thing is, most credible scientists who study this fault line say there is a greater than 50 percent chance we will experience another major earthquake or catastrophic event in the next 50 years. The potential destruction of another New Madrid fault quake could easily total $100 billion, with thousands of lives lost.

While natural disasters cannot be prevented, we can take steps to minimize the financial and physical damage they cause. As you all know, year after year after year after year, we in Congress have to consider legislation to provide supplemental appropriations for post-disaster assistance. Since 1983, disaster assistance has totaled

or cost the taxpayers approximately $75 billion, of which nearly half has gone toward residential loss.

In terms of homeowners' insurance, we know it has become harder to get adequate insurance coverage in some disaster-prone areas of the country. In the past, homeowners in my very rural district enjoyed low earthquake insurance rates. These policies are now beginning to reflect the real risk, and many insurance companies have substantially increased their rates or just refused to write it at all.

Just for example, and I am not complaining specifically about mine, but in the last year my homeowners' insurance has quadrupled in its yearly premium. I have heard from constituents who have made it clear that it is becoming increasingly difficult for them to afford appropriate insurance, particularly those who live on fixed incomes. I think it is time we take a responsible approach to getting a handle on the uncontrollable cost of natural disasters.

As you all know, Bill worked very hard in the last Congress to move the issue forward and came very close. I want to thank you, Mr. Chairman, as well as my colleagues Mr. Lazio and McCollum, for also recognizing the importance of addressing the affordability and availability of homeowners' insurance for folks who live in high-risk areas. I am particularly pleased that you, Mr. Chairman, have seen the need to hold a full committee meeting, because this is the furthest step that has ever been taken on this type of legislation, and I sure hope that it represents an important signal that we will in fact take this legislation up in the 105th Congress.

And I want to reiterate something my colleague from California said. I do think this is a national problem, and I realize those folks and those colleagues of ours who live in States that are not prone to disaster—I hope that they will understand the need for us to do something in a Federal way, certainly through the taxpayer supplemental appropriations bills that we have to come up with every year. The folks in their States are paying for natural disasters, so we need a national solution to this.

But, again, Mr. Chairman, I want to thank you for allowing me to testify today. I pledge to do whatever I can to help you and all of our colleagues find a solution to this very critical problem. Thank you.

Chairman LEACH. Thank you, Mrs. Emerson.

Ms. Christian-Green.

STATEMENT OF HON. DONNA M. CHRISTIAN-GREEN, A DELEGATE IN CONGRESS FROM THE U.S. VIRGIN ISLANDS

Ms. CHRISTIAN-GREEN. I want to also thank you, Chairman Leach and Ranking Member LaFalce and Members of the Banking Committee, for holding this hearing and for the opportunity to testify in support of H.R. 219, legislation which, if enacted, would begin to address a problem that those of us from disaster-prone areas face, the lack of affordable disaster insurance.

I want to take this opportunity also to thank Chairman Lazio and my friend, Vic Fazio, for the wisdom and bipartisan leadership you have shown in introducing H.R. 219 and moving it to this point today, and Mr. McCollum also for your leadership in this regard.

While it is true H.R. 219 does not address all of the various concerns regarding lack of disaster insurance, it does, however, provide us with a good start. I am very proud, Mr. Chairman, to represent the people of, as you have said, one of the most beautiful places under the American flag, the U.S. Virgin Islands.

We live in an area that has seen its share of violent hurricanes, two major storms within six years, and is threatened every year. Prior to 1989 we were spared for over 60 years of being hit by one of these storms. Then in September of 1989 Hurricane Hugo hit, with sustained winds in excess of 200 miles per hour. It was the worst disaster FEMA responded to until that point, and the islands were changed forever, as were many lives.

Devastation brought by the storm was astronomical, but if having to deal with recovering from a major disaster was not enough, the experience of Hurricane Hugo left the Virgin Islands with even a more ominous legacy. It almost completely wiped out the availability of affordable windstorm insurance in our Territory. Then, as if to add insult to injury, just as the islands were beginning to recover from the legacy of Hurricane Hugo, we were hit with a second devastating storm in September of 1995, Hurricane Marilyn.

Mr. Chairman and colleagues, I experienced both of those hurricanes and I hope and pray I will never have to go through that experience again. I cannot begin to tell you, Mr. Chairman, the level of concern and anxiety Virgin Islanders feel today concerning the lack of affordable homeowners' insurance. It continues to be among the top two or three concerns raised to me by my constituents, many of whom could not qualify for needed SBA disaster loans to repair their storm-damaged homes because they could not afford the required insurance.

Even though windstorm insurance is for the most part generally available on the Virgin Islands today, because of its prohibitive cost a huge segment of my constituents sadly remain uninsured and at the mercy of nature. Many of them believe or at least hope that since it was 60 years before we were affected by a major hurricane, it will be another 60 years before we will be hit by another storm of such magnitude. With more pressing and immediate needs, they are rolling the dice, using their scarce dollars elsewhere and not spending it on expensive windstorm insurance, in the hope that their 60-year bet will pay off.

Mr. Chairman, we need H.R. 219 or a similar proposal so that the Virgin Islands and other similar disaster-prone areas can begin to address the problem of the lack of available disaster insurance. In recent years it seems as though our country faces some new disaster every day. Whether it was the floods of South Dakota last year, or recent El Nino-driven tornadoes in the South, or the interminable rains in the West, the cost to taxpayers in addressing these disasters is approaching a point of unaffordability, even for the Federal Government, where it is putting a serious strain on our budget.

This is an important issue, as has been said, not only to my constituents but to the entire country. That is why I pledge to work with you, Chairman Leach, Chairman Lazio, as well as my colleagues, Mr. Fazio and Mr. McCollum, and all other Members of Congress who are concerned about the lack of affordable home-

owners' insurance in disaster-prone areas and want to do something about it.

H.R. 219 is a good start because it would reduce the escalating cost of disasters to the Federal Government by encouraging more private insurers to sell standard homeowners' policies that include protection against natural disasters to residents of areas such as the U.S. Virgin Islands. I thank you again, Mr. Chairman, for the opportunity to make this statement, and I would be happy to answer any questions that you might have.

Chairman LEACH. Thank you very much.

Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman. I just want to compliment all three of the witnesses. Each has contributed significantly to the debate and movement of this legislation at this point.

And while Rick Lazio and Bill McCollum get a lot of discussion and names mentioned in this, there is no question the late Bill Emerson, Jo Ann, your husband, made a huge difference in the ability of us to even be here today, and we are all very proud of that heritage and want to make sure we put the ball across the goal line.

Vic Fazio, you made this is truly bipartisan effort. California is affected in a major way every year and all of us know that, as is Florida. But as has been pointed out so much, Dr. Green, in all of the things that you said, the issue is truly national.

Jo Ann, as you have said, every State has a role to play in this. So I just want to compliment you. I don't want to ask questions because I know that we share the same common bottom line and it wouldn't be productive for me to be taking up time asking questions. But thank you, and I think this bill should be dedicated to the memory of your late husband.

Mrs. EMERSON. Thank you very much.

Chairman LEACH. Mr. LaFalce.

Mr. LAFALCE. Thank you very much, Mr. Chairman.

I thank all three of the congressional witnesses, and I look forward to working with you in a very, very constructive way. You have taken the leadership in identifying the problem and coming forth with solutions.

I call your attention to the testimony of the Treasury Department today, which I think is very constructive. I call your attention to the testimony of the Consumer Federation of America, and I look forward to working with you to incorporate the principles that the Administration and these consumer groups believe imperative in any legislation that is to proceed through the legislative process and be enacted into law. We want not simply a bill, but a good bill that effectuates good public policy, and I think that is achievable. I look forward to working with you on that effort.

Chairman LEACH. Mr. Lazio.

Mr. LAZIO. Let me just say we are going to be hearing a lot today about reinsurance, fair plans, the capital markets and CAT funds. But what these witnesses have brought to us, both in terms of their drive to get something done and their dedication to be part of the process, is the real life cost that natural disasters bring, the loss of lives, the devastation to know that your home is gone, maybe your only investment and your only source of savings.

Congresswoman Emerson was talking about her premiums quadrupling. Many families will be completely overcome by that scenario, and they are just people who live in areas that are prone to natural disasters. And so the human cost is important to keep in mind. It is hard to calculate, I think.

You know, people presume if FEMA comes in after a storm that it makes people whole if they don't have insurance. The reality is most people get no more than a couple thousand dollars, and they have their entire principal investment, their home, wiped out because they have not had the availability of insurance.

So I thank these three outstanding witnesses for bringing the human cost to the consideration of this committee.

Chairman LEACH. Ms. Kilpatrick.

Ms. KILPATRICK. Thank you, Mr. Chairman, and to our colleague witnesses for your testimony.

In the three areas represented, did I understand that it is maybe both or either of these scenarios, unable to get insurance because it is not offered, cost-prohibitive because some can't afford it? If you would go down, is it all of those or neither of those or something else we are dealing with this morning?

Mr. FAZIO. I think it is a number of things. In some cases it is not available. In some cases it is available now but not going to be reissued when the policy runs out. In some cases, the increase in the premium is so large that it is unaffordable for people. It particularly works a hardship on the people who need it most, who would have the hardest time recovering if they were uncovered by insurance but who would therefore find it most expensive to remain covered. So it is a series of those issues.

Ms. KILPATRICK. In the instance where people have it, particularly in California, and when they renew the policy and it is no longer offered, what is the reason given for it no longer being offered?

Mr. FAZIO. I would leave that to the insurance companies to perhaps explain to you, but the bottom line is there is simply no way the companies believe they can assume the risk, and therefore they are telling people that they simply are going to have to look to the Government to help them, or their own resources, which far more than Government are what people fall back on when, frankly, they are hit by the kind of disasters we are talking about. Most of the money that we use to recover comes out of our own pockets.

Ms. KILPATRICK. And do you believe that the insurance companies who have written these policies in the past, and over some several years have not had the disasters and now they have them from time to time—we have no control over that, it is a God thing—are they right, in your opinion, are they right for not continuing to offer that coverage?

Mr. FAZIO. I would love all the companies to continue to offer policies, but they are in the business of responding to their stockholders or their mutual participants, and they are not going to make risk decisions that are going to be detrimental to those interests. They no longer see the ability to have any kind of profit emerge from sales in many of these markets.

Ms. KILPATRICK. Thank you.

Mrs. EMERSON. In my district, for example, it is more of a matter of affordability. A couple of years ago, if you remember, we had the New Madrid Earthquake scare and, you know, they were making T-shirts, "This is where the New Madrid Earthquake is going to happen," and we were all watching with bated breath as the earthquake was supposed to happen in a certain time period and it didn't happen.

But, coincidentally perhaps, earthquake insurance rates have in fact gone up since that time, and as I said, mine specifically quadrupled over the last year. While I can't complain about that, it was very low to begin with, and now I am still able to afford it on the salary we make which is very generous, but those folks in my district who are on fixed incomes find it increasingly difficult, and I realize that it is a risk that is being prepared for.

On the other hand, let me just make a comment, if I could, that I think it is real important for all of the stakeholders, I mean people who live in States, consumer groups and insurance companies and reinsurance companies and everybody, to have a seat at the table and to work together to find compromises so that we can in fact come up with legislation. Certainly there has been a lack of will on the part of the people, as I said earlier, in States who are not directly impacted by natural disasters. But one way or the other, they end up paying, so I hope all the stakeholders will in fact sit down at the table and work out a compromise so that we can try to avoid these situations and the lack of availability and affordability in the future.

Ms. KILPATRICK. In Michigan, for the first time in my lifetime there was a tornado last July 2nd in parts of my district. So I guess in El Nino we don't know what is going to happen.

Mrs. EMERSON. No, and it is very scary. I was driving and I was 15 minutes ahead of a tornado in my district the other night, and it is a very scary feeling. Fortunately I made it home, but you just never know when it is going to strike or where.

Ms. CHRISTIAN-GREEN. In the Virgin Islands, some of our insurance companies went out of business, some left the Territory and stopped providing insurance. For a while after both storms we had no windstorm coverage. We now have it, but the cost of premiums is too high for most people to be able to afford it.

Ms. KILPATRICK. Thank you very much.

Chairman LEACH. Mrs. Roukema.

Mrs. ROUKEMA. Thank you, Mr. Chairman. I will decline, but I do appreciate the contribution of the Members on this subject. As Mr. Lazio stated, we need the human component and a deep understanding of that, and I thank you.

Chairman LEACH. Are there other Members?

Yes, Mr. Weygand.

Mr. WEYGAND. Thank you, Mr. Chairman.

I want to thank the Members for testifying here today. I think any of our States that have been hit by hurricanes, tornadoes or floods, and my State is no different than many of yours, we are very sensitive to this issue. Many of the homeowners in the southern part of my State, in my district, have had the same kind of problems.

I was very fortunate the past January to visit the Virgin Islands, and Donna was a gracious host. When you go there you see the devastation that has occurred and the people trying to rebuild their homes. They are doing so because they did not have the availability of homeowners' insurance and they are doing it on their own, at great cost to themselves and they are taking a very long time to recover. That is devastating.

When you hear about a major flood, a storm or a hurricane or a tornado, people focus on the storm, but a lot of times the focus should also be on the cost to people not directly effected by the flood or hurricane or tornado. The concept of a bigger insurance pool and reinsurance really being the basis of this bill. The support for our homeowners that are in very devastated areas is important, so I compliment the sponsors here today and the Chairman for the work they have done on it.

I know that Rick's district in Long Island and my district in Rhode Island, and Bill Delahunt and Barney Frank in Massachusetts, we get hit all the time with hurricanes. We know what you are talking about, and we are very sensitive to it and appreciate your work on this. Thank you.

Chairman LEACH. Thank you.

If there are no more questions, let me just conclude by saying, and this is going to be a little presumptive, but as I look at this panel, I don't know three more decent and thoughtful Members of Congress, and we are very appreciative of your attendance. Thank you.

Chairman LEACH. Our next witness is the Honorable Deputy Secretary of the Treasury, Larry Summers.

Let me just say first, the committee is appreciative of the work that has gone on at the Department of Treasury on this issue and the input of the Secretary. I hope as we go forward, that it will be understood that the committee would want to listen very carefully to the input of the Department of the Treasury as we proceed to the markup process.

Secretary Summers, please proceed.

STATEMENT OF HON. LAWRENCE H. SUMMERS, DEPUTY SECRETARY, UNITED STATES DEPARTMENT OF THE TREASURY

Mr. SUMMERS. Thank you very much, Mr. Chairman.

I have a longer statement which I will submit for the record.

Chairman LEACH. Without objection, it will be put in the record, and if you will hold for one second, I would like to ask unanimous consent that opening statements of any and all Members be placed in the record, and Members who may not be Members of the committee as well.

Without objection, so ordered.

Mr. Summers, please.

Mr. SUMMERS. Thank you. I would like to extend my compliments to you and to Congressmen Lazio, McCollum, Fazio, and many others who have shown leadership on what I think is a vitally important issue.

My purpose here today is to convey that we see much promise in the current legislation as a means of addressing the many problems that currently exist relating to the availability and price of in-

surance and reinsurance for disaster risk. We do, however, have important concerns with specific provisions relating to making sure the taxpayers' interests are fully protected, that any approach we follow rely as much as possible on market forces and not substitute public activity where the private market can do the job.

Natural disasters pose a particularly difficult economic problem. They are extremely infrequent but when they take place have extraordinarily high costs, and it is difficult to estimate with precision the probability of loss and, with precision, the consequences of a natural disaster. For these reasons, prices can be high in relation to expected losses, referred to in the insurance industry as actuarial risk, and coverage in the aftermath of an event may pose a particularly difficult problem for private markets.

And indeed reinsurance prices have come down recently, but for the largest disasters continue to be in the neighborhood of four times actuarial risk. That is, to compensate for a 1 percent probability event, one has to pay a premium of approximately 4 percent.

The rationale for prudent Federal involvement comes from that high price, and it comes from the realities that the Federal Government, by virtue of the scale of its operations, has capacity for diversification across the population and across the economy; that by virtue of its permanence, it has capacity for diversification over time in terms of the ability to accumulate funds or to borrow if disaster occurs before funds have been accumulated; and because of the reality that in the event of a disasters the Federal Government is likely to pickup some portion of the cost in any event.

But what is crucial is that that role be a limited role; that experience with Federal interventions in the credit and insurance markets teach us that it is crucial that we be hardheaded, that we assure the Federal Government is fairly compensated for any value that it provides, that we recognize the fast-changing and maturing state of the capital markets, and that we not allow a Federal role to preempt a more appropriate role for private markets.

These considerations lead us to four principles: Government should provide disaster insurance when it can do so temporarily and on substantially more favorable terms than the private market. It should do so in a manner that avoids imposing net costs on taxpayers, or an adverse deficit impact. It should do so in a way that harnesses existing market forces to the maximum extent and encourages their further development. And it should be prepared to put itself out of the business of doing so when that is appropriate.

We believe H.R. 219 provides a foundation that could, with suitable modifications, be made consistent with these principles, though this does not preclude other approaches. In particular, we continue to view industry excess-of-loss contracts as a potentially valuable way of providing disaster reinsurance to a much broader class of counterparties than State funds. Indeed, an approach that seems promising to us is one that would marry the best ideas of H.R. 219 and H.R. 230. It would be a substantial improvement to the current legislation, to ensure that the playing field is kept level as between State programs and other potential customers of disaster reinsurance.

We do believe that H.R. 219 is a constructive and creative response to a serious situation: the difficulty faced by State funds in purchasing extensive reinsurance against low-probability risks, either because the reinsurance is simply unavailable or because premiums are high. But we have concerns that the pricing decision be sufficiently insulated from political pressures to remain objective.

I suggest that the Secretary should be only able, and I think this provision has been recognized, to adjust the commission's estimate of expected loss upward, and there be clarification of factors to be taken into account in setting the risk load. We have concern that it improve availability and not favor State programs over other possible vehicles for delivery of insurance to homeowners. To this end, we suggest modification to provide for the sale of excess-of-loss contracts to all entities on an unrestricted basis, and we believe consideration should be given to auction mechanisms wherever possible.

Finally, we believe that public involvement needs to be carefully circumscribed, that the program should be sunsetted, that trigger points should be set with a view to the rapid development of the capital market so as not to supplant that capital market, and that the public entities should be authorized to underwrite no more than some specified fraction of the risk faced by any given State fund.

There are a set of more technical suggestions involving questions relating to multiple perils and the way in which State funds operate that are addressed in an appendix to my testimony.

Budgetary treatment of this legislation will be a complex and highly technical subject, but we would hope that legislation could be worked in such a way that it would accomplish our goals without burden to the taxpayers or adding to the budget deficit.

Let me just say in conclusion, Mr. Chairman, that this is an issue that we have recognized as very important for some time. The Administration, as you know, issued a 1995 policy paper on this vital subject.

The panel before me laid out in very clear and stark terms, I think, the human impact that disasters can have and the importance that adequate insurance can have. If we are to wait before acting until a disaster comes, I think we will all feel that we have not served wisely. As the President has said in a very different context, the right time to fix the roof is when the sun is shining. That is why we believe that the current legislation provides a useful vehicle for further progress, thought and development in this area, and we look forward to working with you to improve it.

Thank you very much.

[The prepared statement of Hon. Lawrence H. Summers can be found on page 262 in the appendix.]

Chairman LEACH. Well, I would thank you for your very forthcoming testimony, and simply reiterate again that as this moves forward, we will be paying a great deal of attention to the Treasury recommendations; and my personal view is, the more constructive the approach, the more attention that the committee gives to the Treasury.

Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

I greatly appreciate, Dr. Summers, your testimony today, and what I think is a fairly strong statement of support for the direction, in general, that we want to head, as Mr. Lazio and I have been working on it. But I would like to ask a question that gets to the heart of what is the central issue here in terms of what we deliberate on in modifying H.R. 219 or not.

In the way the version of the bill is at the present moment, as I understand it, the catastrophic reinsurance would go to State-sponsored funds or to States who would set up an auction system; but in any event, the reinsurance would be State by State and through a State-sponsored program.

You said in your testimony, in addition, as I indicated before, we believe the legislation should be modified to provide for the sale of excess-of-loss contracts to all entities on an unrestricted basis.

Some of the witnesses who are going to come along later are going to be supportive of keeping it the way it is; some are going to be supportive of going to an excess-of-loss system. One who favors going to the excess-of-loss contracts is suggesting that that methodology will provide a vehicle for insurers and reinsurers to create a secondary market, and that it is more favorable to the private marketplace.

First of all, I don't think everybody here knows what an excess-of-loss contract is, and I wondered if you would explain to the committee what you think of as an excess-of-loss contract, and how you would envision—I know there are no details here, the Administration doesn't have a legislative proposal, but how you would envision our modifying this or, more importantly, why you think that we should modify H.R. 219 to provide an unrestricted basis for people to be able to purchase, insurers to be able to purchase such contracts.

So if you could, define what an excess-of-loss contract is and the rationale of why you think that would be a preferable or needed modification to the bill.

Mr. SUMMERS. An excess-of-loss contract, Congressman McCollum, I think of as a contract which provides for a slice of reinsurance, for example—and there is no significance to the numbers I am choosing—that would provide for reinsurance on catastrophes in excess, nationwide, of $20 billion and less than $30 billion. That would be a contract that would cover—it is called excess-of-loss because it is the excess above $20 billion.

Frequently, as these are thought of, they are thought of with a cap, so that would be $10 billion of potential liability; and one could imagine auctioning off a portion of that 1 percent. If you auctioned off 1 percent of it, you would be auctioning off $100 million of potential liability and a contract that perhaps would pay $50 million if there was $25 billion worth of damage, $75 million if there was $27.5 billion worth of damage and so forth.

And the excess-of-loss proposals typically envision that the contracts pay out above some threshold for some defined area and class of catastrophes and that the contract would be auctioned off and then would be purchased by those who wished, for one reason or another, to hedge against insurance that they had provided.

The very substantial appeal of the XOL approach is that it is, in a sense—small "d"—democratic. It provides for anyone who wants

to be in the insurance business to be able to hedge and it doesn't target any particular class of actors. And that is why we think it is very important that in any ultimate proposal there be an excess-of-loss element, so that it would be desirable to provide for that kind of reinsurance.

The other issue, and I suspect it is an issue frankly that Congressman Lazio can speak to much more knowledgeably than I can, is the reality that in several States there exist State funds that are providing an important service, are playing an important role, and that it is important that whatever approach we take be one that is consistent with that. And if, for example, the concern has been expressed that what was available was a national fund, or even a State fund, or even a regional fund that did not match the set of liabilities that a State fund had, then it would be rather difficult for the vehicle to be constructive for the State fund.

So, I think what is necessary—and I do not have a specific formula to suggest to you here today—is some synthesis that achieves both the objective of being able to provide support for a State fund, but also in no way encouraging, as the only way to get support, other States to set up State funds or tilting the playing field in favor of the State fund approach.

Mr. McCollum. I know my time has expired, and I concur, being from a State like Florida that has one of these funds, I don't want to do anything to undermine that fund. But if you had excess-of-loss contracts, would there be an ability to have a private marketplace for the sale of—a secondary market for the sale of those bonds that would be created by this?

Mr. Summers. I think—in a general way, I think the presence of excess-of-loss contracts would in all likelihood be quite conducive to the further development of what is already a rapidly growing private capital market in these kinds of instruments.

Mr. McCollum. Thank you very much. Thank you, Mr. Chairman.

Chairman Leach. Thank you, Mr. McCollum.

Mr. LaFalce.

Mr. LaFalce. Thank you very much, Mr. Chairman.

Secretary Summers, thank you for your thoughtful testimony. It is very helpful to the committee that Treasury has now come as far as they have come in supporting the concept of Federal involvement and articulating some principles that must be included within legislation if we are to have sound public policy. But I would hope that Treasury could now go beyond that articulation of principles and work with the committee in the fashioning of legislation and the drafting of legislation itself.

I think H.R. 219, as reported by the subcommittee, falls short of meeting those principles, and that is why, for example, the consumers group opposes it as it presently stands. They have articulated principles which I believe in large part mirror the principles that you have articulated, as I view them. I think there is a tremendous similarity of an identity of viewpoint.

I actually think you are closer to Mr. McCollum's H.R. 230 than you are to H.R. 219, or some merger of the two with an inclusion of the principles. So I almost think it would be helpful to almost virtually start from scratch, to the extent Treasury could assist us

in drafting legislation, I think that you would expedite the process tremendously, so I would encourage you to do that.

Now, if there is difficulty in winding your way through the OMB process, then I would suggest you give us a bill, but with as many technical and improving amendments as is necessary to make a whole bill consistent with the principles. That's all I have to say.

Mr. SUMMERS. Thank you. Thank you very much, Congressman.

I am told that the principles that I have suggested are indeed quite similar to the principles, as we see it, that the consumer groups have testified.

I don't have a view here now about the precise modalities, but we certainly would like very much to be as cooperative as we can be with the committee as this process moves forward. And I might just say, because I know many of them are represented in this room, that I think this is a process that none of us in the Government will be able to complete well without very extensive consultation with the various stakeholders in this whole process, both in the primary insurance market, the reinsurance market, the capital markets, which are so promising for this issue, State governments, and so forth.

Mr. LAFALCE. And I want to reiterate that there is a tremendous diversity of opinion among the States as to the appropriate approach, and there is a tremendous diversity of opinion among the totality of the insurance industry as to the appropriate approach. There is not monolithic State thinking, there is not monolithic insurance thinking on this issue at all, and we need to be aware of that as we draft legislation, not to make everybody happy, but to effectuate sound public policy.

Mr. SUMMERS. I agree with you, Congressman, and I think that has much to do with the fact that this is not the first Congress in which this issue has been raised, but I would hope that all the various parties might recognize a common stake in finding a solution and that none would let the very best be the enemy of the good.

Chairman LEACH. If the gentleman will yield, let me just reiterate part of what Mr. LaFalce has said, A, that there is a terrific appreciation for the movement and involvement of the Department of the Treasury.

We are going to be moving on a reasonably proficient basis toward markup, and in that regard, the more definitive the assistance of the Department of the Treasury, the better. And so I would like, I mean, just very precisely, A, to request very specific legislative language from the Department, and B, to ask if the Department is prepared to provide such.

Mr. SUMMERS. Mr. Chairman, we want to be as cooperative as we can. Whether we are prepared in a formal way to provide the legislative language is something I think would have to be considered very carefully from a range of points of view. But certainly in terms of providing the kind of substantive input that would allow a discussion of how the existing vehicle could be improved to reflect these concerns, I think we are prepared to be very active.

Chairman LEACH. I am appreciative of that. And I know of the reservations you have, but let me also be very definitive in suggesting, we are dealing with an area of legislation that is relatively novel to the Congress, and it involves very precise legislative

craftsmanship, as well as generalized principles. And so, as you understand, the committee has been asking for over a year for a direct input from the Department of the Treasury.

And we are very appreciative of the statement today and the testimony today, and the generalized principles, but we also are requesting, you know, as forthcomingly as the committee can, for substantive input of a legislative language nature. And Mr. LaFalce has referenced a problem, all departments have, with regard to OMB clearance, which is sometimes awkward.

On the other hand, all departments, generally speaking, when requested by committees, are prepared to forthcomingly come up with specific language and specific approaches, and so I would be very hopeful that this Treasury would be as forthcoming as is generally the case.

Mr. SUMMERS. I appreciate what you are saying, and we will be as forthcoming as we can be, and I think we appreciate very much the faith you show in us by recognizing what I think is a very capable technical staff at the Treasury who can do this; and I would only express the hope—and I say this not totally seriously, Mr. Chairman—that on all the other difficult issues that we face, there could be a similar coveting of the Treasury's input. There are other matters within the committee's jurisdiction in which we would be delighted to suggest legislative language if we expected it would be put in place.

Chairman LEACH. As you know, this committee has voted 40 to 9 on the IMF bill.

Mr. SUMMERS. Absolutely. And for that we are very appreciative.

Chairman LEACH. There is no such thing as *quid pro quos* from one issue to another, but this committee is dedicated to a professional appraisal of the issues. And frankly, it has been my long-term assessment of the Department of the Treasury that it is an institution with enormous professional capacities, and we look to the Department of the Treasury for advice and judgment on a spectrum of issues, and we will deal with the Department as professionally as we can.

Mr. SUMMERS. I appreciate that. And it has now been over five years that I have been at the Department of the Treasury; and since then I think we have very much valued on a whole range of subjects, both domestic and international, our professional interaction with you, Mr. Chairman, and with the committee, with the committee more generally, and we will be as helpful as we can be.

Chairman LEACH. Thank you.

Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman.

I want to thank the Secretary for his constructive comments today and for his commitment to the process, and I want once again to associate myself, as I did earlier during the course of this hearing, with your comments regarding the fact that now is the time to address the concerns that you have aired and others have aired. It is not for us to drag our feet or wait until hurricane season or a natural catastrophe is upon us, where the political pressure will be overwhelming to try and react in a manner that may not provide us with enough time to vet these issues and to work out the concerns that you and others have aired. I am a big pro-

ponent of being preventative now, to move forward, to be proactive to deal with this problem.

As you mentioned, this has been the subject of several Congresses over several years; and in the last Congress as a matter of fact, Senator Stevens had a version of the bill, which he believed had broad-based support, which he later found out that was not the case. And so, in the sense of clarity and constructive engagement, it is very, very important. I also want to associate myself with Chairman Leach's comments with respect to those.

Obviously, by virtue of your comment about the need to move now and not wait for the inevitable disaster to hit, you believe that there is an appropriate role for the Federal Government to play in providing the incentive for liquidity in the insurance marketplace, the homeowners' insurance marketplace. Let me ask you if you can confirm that and ask you, as a follow-up, in the course of your answering that question, what your view is of the current capacity of the reinsurance industry on a regional basis, and of the capital markets to deal with the concentration of risk as a result of one of these natural disasters.

Mr. SUMMERS. I think there is a role for the Federal Government, Congressman Lazio, and I would characterize the capacity of the reinsurance and capital markets as substantial, growing, and not totally adequate; and that is why I see a role for the Federal Government. But that is also why I think we have to think very, very carefully about the dimensions of that Federal role, the dimensions in scale and also the dimensions in time.

I think we are all familiar with Federal interventions to improve the function of the financial markets that perhaps outlived their rationale; and I think that is something to which we need to be very sensitive in thinking about proposals in this area. And I think we do need to look carefully at issues of trigger, issues of fraction of insurance provided, issues of discrimination, who has access to benefits, in order to assure that we are pursuing an approach that does what we need to do, but doesn't do more than we need to do.

Mr. LAZIO. I think I would agree with that, and I think H.R. 219 honors those principles of having respect for the private sector, not wanting to substitute for present capacity and envisioning a temporary role for the Federal Government. I would remind you of the role the Federal Government had in the 1960's, with urban unrest and the fact that there was a problem with insurance capacity in many of our urban areas after some of the riots; and the Federal Government did come in and provide some assurance to the market, and within a few years, it was no longer necessary and the private sector grew back into it. And it is not the model—the end result—we would like to see happen to provide enough incentives for the private sector to grow, but as you say, understand it is not adequate in many cases, grossly inadequate, particularly in some of the urbanized areas in the West that are highly prone to natural disasters, to absorb that level of loss.

Mr. SUMMERS. After we discussed this question, Congressman, you sent me a very thoughtful letter describing a number of examples in which adjustments had been made when their need was not there and suggesting that in a number of cases what was seen as perhaps inappropriate today was not actually a case of long-term

political distortion, but was, rightly or wrongly, a case of original intent. And I think that is a very important perspective on this.

I do think we need to be careful, because this is the only place where I might have a slightly different view than the way in which you spoke. It characterized the private market as substantial and growing, and so I think it is important that we recognize that present capacity will soon be growing, and we need to be careful not to cut that growth off, but I think this is a matter for working things out.

Mr. LAZIO. I agree, and I would mention in the context of the State programs, for example, California or Florida, there is an enormous capacity to grow both the capital market and reinsurance industry role in those plans before we even get near to triggering a Federal backstop, so there is enormous growth potential in both industries.

Chairman LEACH. Thank you, Mr. Lazio.

Mr. Kennedy.

Mr. KENNEDY. Thank you very much, Mr. Chairman.

First of all, I want to welcome my good friend and constituent—I guess you still vote in the 8th District—not that that is going to matter a lot to me in the next few months. So now I can say whatever I want here, right, Larry?

But, Mr. Chairman, I first of all, want to thank you for holding this hearing and I apologize for having to be at another hearing earlier today. But I want to just suggest that we ought to move with caution on this whole issue of how to proceed with regard to the concerns of these major catastrophes that could take place.

I think everyone who is concerned about this issue, first of all ought to recognize that the reinsurance companies themselves indicated to me in a series of meetings that this is an issue they feel they can handle themselves. So that is one set of issues. You know, whether or not that is true is something that can be looked at. But the fact of the matter is they do indicate they can make up much of this gap.

Second, I think we don't ever want to get ourselves into a situation where we are privatizing the profits of the insurance industry and then publicizing the losses of the insurance industry. I think that is an overall concern that I hope the Administration keeps at the forefront of its agenda.

And third, I think that there is a question of whether or not—if we are going to move forward with the whole issue of catastrophic insurance, whether or not this isn't something that everybody in the country has to participate in. Because if you limit it basically to the three States where these catastrophes are most likely to exist and leave it only to the private sector or to, as this bill that is before us calls for, leave it to the individuals that would be affected in those States to pay for it—they simply won't buy the insurance. That is the experience that has been borne out in the California example. We should also recognize that if the State of California, the State of Florida or some other State gets hit by one of the catastrophes, we view this as a national issue and it is something we are going to have to come to grips with.

So what I would like to just get your reaction on, Mr. Summers, is your general concern about those three basic issues in terms of

reinsurance, of whether or not the Government ends up picking up the tab for something that private industry ought to, and of whether or not we really have to look at a national base in order to make this insurance actually affordable for people in the local communities.

Mr. SUMMERS. Congressman Kennedy, I would agree very much with your call for caution, and I think the degree of caution that we have displayed in getting to this point has been frustrating for some. I think there is no question that the reinsurance industry can and does play an absolutely crucial role, and I think that, as the committee will hear, I think, later in the day from the representatives of the capital markets, they too have a very substantial contribution.

It is our judgment, as I think it is the judgment of many in the reinsurance industry, though not all, that with respect to the largest catastrophes, there is a role for a kind of Federal backstop, at least on a temporary basis, because unlimited capacity is not there in the reinsurance industry.

The national-local question is a very difficult one, the premise on which I think the bill is constructed, and in a way, the premise on which my comments are constructed is that it is not our goal to have subsidy; it is our objective that market forces operate and that those who are purchasing insurance in California should pay a premium that reflects risks in California, and similarly for those in Kansas, and similarly for those in Somerville. But the difficulty is when, because of limits in the capacity to bear risk and the scale of the market, that premium exceeds by a factor of four or more what the actuarial cost of the insurance is, and that the objective of the Federal Government's involvement in this area would be to bring down that ratio and to bring down premiums and make homeowners' better. But that would not involve any subsidy from other parts of the country to the parts that were most likely to have large catastrophes.

Mr. KENNEDY. Well, this is the kind of good old Federal money we used to have, Larry. How are we going to get the money to subsidize if you don't get people in Somerville. I don't think the people in Somerville are necessarily going to mind. They are concerned about a massive hurricane hitting Boston, so I am not certain that there is such an unwillingness of people up there to help out in a matter like this.

Mr. SUMMERS. I think we need to look at that. We need to look at the set of issues closely, and I certainly don't have all of the answers, that the basic source, though, is that, as I have tried to— my written statement tries to say, the Federal Government by virtue of its large scale and diversification in effect can pool risks.

Mr. KENNEDY. But you are pooling risks by taking tax money from someone else and putting it into another guy's backyard, right?

Mr. SUMMERS. I think not, because I think that assuming the pricing is right, over time the premiums that you charge would be lower than the premiums that would have been charged in the absence of this reinsurance, but will still be more than sufficient over time to cover the payouts, the payouts that result.

Mr. KENNEDY. Mr. Chairman, I know my time has expired, but that sounded like as good a double-speak as I have heard Alan Greenspan give up there. But in any event, it doesn't sound to me as though you can say on the one hand that you are not providing a subsidy from one part of the country to another, and then say that, in fact, if the premiums are over four times what the cost of the disaster might be, therefore, you are going to get the Federal Government to somehow reduce the prices.

It either is or it isn't. What I am saying to you is, let's be honest and say it is, and then let's go out and tell the people of this country if there is going to be a major disaster anywhere in America that all of us, as fellow Americans, have a responsibility to look out for one another. For a very small premium that can be charged across the entire United States, you can provide this insurance. I think that is a much more safe, secure and fundamentally honest way to move forward, rather than to try to suggest this can be done by going to three States and asking the people of those three States that are, after all, more than likely, having to participate.

And in the experience of California, you simply can't price this insurance in a way where the people are going to voluntarily purchase it. So I think there is a flaw in the way this bill has been constructed. I don't think that we are going to be able to make any progress in actually solving the problem. We might pass a bill, but you won't solve a problem the way the bill is currently structured.

Mr. SUMMERS. I just want to clarify one aspect of that, one aspect of our position. It is not our intent to ask those who are living in less risky parts of the country to subsidize or to cover or to pay taxes in order to bear the risks that those who live in higher-cost parts of the country face. That does mean that what we are limited to is the benefit that can be provided in the riskier areas from the improved risk-bearing capacity of the Federal Government; and as you said, there are limits to how far you can bring down the premium because, after all, it is more likely you will have an earthquake in some parts of the country than others.

Nonetheless, I think it is our judgment it is possible to bring about some improvement in that way and that that is valuable improvement. There is a much broader and more philosophical kind of discussion about whether nationally, we should have a redistribution from the parts of the country that are less disaster-prone to the parts of the country that are more disaster-prone. One can make arguments on both sides of that.

That is not what I think is contemplated in the range of proposals under discussion here and that is not something that at this point we would be prepared to endorse. Nonetheless, I think something constructive can be done in what is a relatively small number of States, where the catastrophe risk is so large as to be beyond the potential of the private market. In many other places, the private market is more able to handle the problem.

Mr. KENNEDY. All I would say in response is, look at the tables of who participates in California when you actually provide the exact kind of model that this bill calls for on a national basis. People won't buy it because it is too expensive.

Mr. SUMMERS. Without going into the arguments as to how it would work, if successful, as I understand the philosophy of all of

these approaches, it is that by improving the availability and pricing of reinsurance, what one would have is lower-cost primary insurance and, therefore, do two things: One is expand, by reducing the price, the number of people who took advantage of primary insurance; and second, and what I think some day what we may discover is very, very important, ensure that those who have primary insurance actually get the insurance they think they bought, because there is the solvency to meet the obligation, which has been a problem in the past in this country with a number of different classes of financial intermediaries.

Mr. KENNEDY. Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

I do think, though, the committee deserves an unequivocal response on the ancillary question, and that relates to one of the most thoughtful and involved Members of this committee, who is unfortunately giving up his seat. Are you a candidate to replace him?

Mr. KENNEDY. Come on, Larry.

Mr. SUMMERS. It is rare that people do this, but I will make an unequivocal Sherman statement with respect to that particular notion. If nominated, I will not run; if elected, I will not serve.

Chairman LEACH. Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman.

Mr. Summers, you stated that you see the current situation as substantial and growing but not yet adequate. If the market is substantial and growing, and we don't want to cut off that growth, then how expensive a dwelling loss disaster has to occur before the Government needs to step in? What does Treasury think the number is, $10-, $15-, $25-billion? What is the number?

Mr. SUMMERS. I don't have a particular number to give you. I think that while we have engaged in a certain amount of consultation, I think before coming to a judgment about a number, it would be appropriate to engage in much more extensive consultation than we have yet had an opportunity to do.

I think I would say, and I know this is something everyone recognizes is very much fluid, that the $10 billion, on a national basis, figure that was contained in H.R. 230 strikes me as very likely to be too low a figure relative to what I would regard as appropriate and, almost certainly, too low by a significant factor. But just what the right number is I am not prepared to say at this point.

Mrs. KELLY. Has Treasury studied this?

Mr. SUMMERS. Treasury has thought about this and has consulted and received views from a number of corridors and considered it. I am not sure I would want to dignify the work we have done so far as a study, but we have certainly looked at the question.

Mrs. KELLY. In the process of the help that you volunteered to work with this committee on, perhaps you think you can provide us with some sort of help with a number.

Mr. SUMMERS. I am sure we can provide the guidance to the committee in setting an appropriate figure, and of course, this is a little more complicated than just providing one number, because it depends on whether one is looking at the Federal level or one is looking at particular States. But I think we can—I would imagine,

in working with the committee, we would be in a position to provide guidance on the set of questions around triggers, yes.

Mrs. KELLY. OK, thank you.

You mentioned flexibility. I am curious about how that can be achieved to promote a private sector reinsurance growth. Since H.R. 219 has two different approaches, the catastrophic or the State XOL contracts, do you see them as working together or independently? Talk to me a little bit, if you can, to kind of explain to us a little bit more what you mean by "flexibility" and how you see that in the framework of H.R. 219.

Mr. SUMMERS. I would hope that any legislation that would ultimately pass would include a provision for XOL contracts, whether on a national basis or on a regional basis, which would be eligible for anyone to buy at auction, and that the availability of those contracts would, in turn, make it possible for them to compete in—for those who purchased it—to compete in the downstream insurance market. I don't think that the Federal Government should confine its assistance to particular buyers, as I think any seller knows that it is likely to have its product distributed more effectively if it provides for multiplicity of buyers and competition, rather than a single buyer.

I think that is the approach that we need—that the Federal Government should take. Just what the right means are is a very complicated subject; I think it is difficult to discuss in this forum.

Mrs. KELLY. Thank you. One final question. Currently, insurers can deduct losses against profits and save taxes by applying them back 2 years and forward 18. What effect has that had on the Federal tax revenue? And I am curious about whether or not this is adequate to address the routine insurer loss.

Mr. SUMMERS. I can get you an answer in writing that is more specific than the answer that I can give you here.

Clearly, when you are dealing with large disasters that would cause the income in one year to be radically different, it is appropriate to have loss carry-forwards and loss carry-backs. So I think there is a question about exactly the right loss carry-forwards and loss carry-backs. Of course, any change in loss carry-forwards and loss carry-backs would represent a budget item that would have to be scored as having an adverse impact on the deficit; and I think a virtue of the kind of approaches that are being discussed here is that they have the potential to be revenue neutral, because a super-actuarial premium is being collected for the Government in return for any insurance that is provided.

Mrs. KELLY. Thank you very much. Perhaps we can enter a dialogue about those last two questions at some later date.

Mr. SUMMERS. I would like that very much.

Mrs. KELLY. Thank you very much.

Chairman LEACH. Thank you, Mrs. Kelly.

Mr. Vento.

Mr. VENTO. Thanks, Mr. Chairman.

Mr. Summers, I appreciated your statement. You pointed out that one of the major concerns here is that this would not be—that the actual charge for the policies that are either instituted by the State or the private sector on this, before we get to the reinsurance, be sound. Is that, that they be actuarially sound? I mean, I know

there was an amendment offered like that in the subcommittee. Does that satisfy the concern or what do you mean that they be realistic? Obviously, if you are reinsuring, you want to make certain the folks in front of you are real with their money.

Mr. SUMMERS. I am sorry, Congressman Vento; I am not trying to be evasive, but I am not understanding the question you are asking.

Mr. VENTO. Well, your concern was, your first concern was that—in fact, your major concern, I understood; and I can't find it right now.

Mr. SUMMERS. Oh, I see, that pricing decisions be sufficiently insulated and so forth?

Mr. VENTO. Yes.

Mr. SUMMERS. I think there are historical grounds for worrying that when the Federal Government agrees that it is going to provide a service and it is going to charge an appropriate price that covers its costs for its service, that over time the people who are principally interested in the matter are the people who are going to buy the service, and that the political process feels pressure to price it in a way that is attractive to the buyers. And over time, the Federal Government, which thought it was doing something that was going to be revenue neutral, ends up doing something that is quite costly to it. I think we have seen that kind of thing in other Government insurance programs.

My point was just to emphasize—and I think this is something that is possible to do—that we need to find mechanisms such as a commission that reports, that would insure integrity to the process and would prevent that kind of erosion.

Mr. VENTO. Well, that is right. I think as we go down the road in the decades to come that the initial insurance, that your reinsuring may end up being more of a mirror than anything substantive. So instead of being a dynamic process, there ends up being a thinner and thinner layer of insurance, and especially with the catastrophic type of events.

And I suspect that one of the reasons the various States, with regard to hurricanes and earthquakes, have discontinued this particular insurance activity is because there are almost certain losses based on the tectonic and other meteorological information that is available. It is obviously trying to insure, you know, housing, businesses. I know this is just dealing with residential, but in these various zones, it is just about a sure loser. You would have to charge the type Bs.

So they have actually withdrawn from some States, and the idea is through this Federal reinsurance, to in fact try to recreate, as it were, to make it possible to have insurance in these instances, is my understanding of this.

Mr. SUMMERS. That is right. That is right, Congressman Vento, but I would qualify what you said in one way. Where there is a high probability—I am not a geologist or meteorologist, but where there is a high probability of disaster, any actuarial fair premium, if there is a 10 percent probability of a home being destroyed each year, then you would have to charge as a premium at least 10 percent of the value of the home if you were going to have any chance.

Where it is that kind of situation, frankly, the bills under discussion here are not going to actually address the problem.

What these bills are addressed at is a different problem, which is the very large disaster that actually has a low probability, of 1 percent or less, of taking place, but people, knowing if the 1 percent comes up, they will be bankrupted, are very reluctant to write that kind of insurance or charge a very, very high fee for that insurance.

And so it is not the general problem of high risk in dangerous areas that can be addressed through a reinsurance approach of this kind; rather, it is the people worried about the 1-in–100 shot, who therefore withdraw from the market.

Mr. VENTO. I have two concerns, one for the Federal Government, as we are collecting these premiums, that there not be a rebate policy in place and that we have some security, that as we are collecting the premiums—because I think there is a tendency of California, Florida and a few States that are paying this in, to think that it is their money. And I have seen it happen before and there are concerns about that.

Second, in your statement, the impression I got, and you can correct it if it is wrong—not with a long statement because you don't have a lot of time—but you would like to see this expanded to different categories of catastrophe; that's the way I read one of the lines here.

And, second, I am concerned about your statement in here about mitigation. I believe that Mr. Maloney offered an amendment on mitigation, and you suggest you do not want a specific percentage of earnings spent on mitigation. OK, that's fine, but I think we need to be concerned about mitigation because, indeed, if one of the other risks in terms of making this actuarially sound is to make certain that construction isn't going on on properties that are likely to sustain substantial damage—we have V zones, we have flood zone protection, and a lot of extra activities; and the message that ought to come out of this legislation is that we do not want to be funding residential, or for that matter, business, if we get to that, structures that are not adequately or soundly constructed for the type of events that occur in a particular location, nor in sites that are highly probable to be subject to types of damage.

So those are my concerns, that the money not be rebated and that in terms of the percentage of mitigation that we are not completely ignoring the issue of mitigation actions in terms of construction in activities that we are insuring.

Mr. SUMMERS. Congressman Vento, I think all of your concerns are very important. One, I do think we have to be very careful with the political mechanisms we take with respect to the premiums, that we understand these are premiums for low probability events, and we don't dissipate them in the period before the low probability event takes place. And there is a reference to that in my testimony, but I think crafting the right kind of institutional approach to doing that is a critical challenge, I agree with you very strongly.

Mr. VENTO. Rebates would be one way to do it.

Mr. SUMMERS. I would certainly support that. Other catastrophes, I think the principle should be where it is a low prob-

ability, big damage, and therefore difficult for the private market to handle, we should do it, it should in principle be done.

Where it is a more routine kind of once-every-three-year event, I think we have much more presumption of relying on private market forces. And while we did have some technical concerns about the specific proposal that was put forward, I very much share your view that mitigation is an important piece of this.

The original legislative process on this had sought to combine approaching the issues that we are discussing here with approaching a range of other issues involving mitigation, and also involving regulation of insurance; and I think the feeling at this point, which I am inclined to share, was that the best prospects for moving ahead were with a vehicle that was focused on, if you like, the capital market and reinsurance aspects.

But I very much share your concern and I suspect we could be comfortable with approaches that in some way married some aspect of mitigation to this. Of course, funds that are used, premiums that are used to reinforce structures are not available to then pay for the subsequent disaster, so one has to—although, of course, they reduce the damage from that disaster. So I think one has to be careful with respect to the approach, but the basic direction you are espousing I very much agree with.

Mr. VENTO. Thank you, Mr. Chairman.

Chairman LEACH. Well, thank you very much.

Now we would like to turn to one of the committee's insurance experts, who, I suspect, wants to ask about snow slides, but Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman. Avalanches we will talk about.

Mr. Summers, first I want to echo the comments of other colleagues about your thoughtful testimony. It seems to me your comments about the fact we have a substantial and growing market for reinsurance and contingent capital, different mechanisms for dealing with the problems of solvency here, I think is accurate.

The real question is, is there some expectation that is going to be stable? Reinsurance premiums and insurance premiums are extraordinarily volatile. That is the history of this industry. Could you comment on that? I mean, do you believe there is stability in that pricing now or do you have any expectation of any stability in that pricing?

Mr. SUMMERS. I think you raise a very, very important point, Congressman Hill. I think it is difficult to fully sort out, in terms of the growth of involvement in reinsurance in the capital markets, how much of it is desirable innovation that will be permanent and how much of it is a response to the fact that after rather difficult years in the early 1990's, from the point of view of catastrophes, the world has been somewhat more fortunate. And certainly, the historical experience is that there is a substantial, if you like, second accident problem; and in the event of a major event, in its wake, I suspect that there would be calibration of all the models and such and that the insurance would be less available than it is—insurance will be less available than it is right now. I think that is another rationale for there being a Government backstop.

Mr. HILL. This raises the threshold?

Mr. SUMMERS. I think that is fair.

Mr. HILL. I guess my starting point for this is, first, do no harm, and I have a concern about whether or not this bill will create an incentive for the creation of more State funds or pools.

What is your opinion about that? Do you think that this will create an incentive for more State funds and more pools?

Mr. SUMMERS. I would put it slightly differently, but I would share the concern.

I worry that the bill, as it is written, tilts the playing field more than perhaps it should to public sector solutions at the State and local level and that that tilt could be addressed by adding features that provided for excess-of-loss.

Mr. HILL. Would you share my view that if this does create an incentive for the creation of more funds and pools, that could have an adverse impact on the marketplace responding to, this further response to this issue.

Mr. SUMMERS. I think there is a real concern there, yes.

Mr. HILL. You know, we compare apples and oranges here when we look at Florida, California, Hawaii; I mean, these are really different solutions to similar problems, and the only similarity really is catastrophic exposure. But one of the common threads throughout all of those solutions is that they give special tax treatment to the accumulation of reserves for the purposes of building a financing pool to pay catastrophic losses; that is universal in all of those.

Why wouldn't it be a good idea to create a mechanism to encourage in the private marketplace more favorable tax treatment of the accumulation of reserves that are focused on addressing catastrophic exposures? Wouldn't that level the playing field between the public sector and private sector solutions?

Mr. SUMMERS. I think there is a case to be made in that direction. It, I think, is limited by two factors. One, any such approach would have budget costs and perhaps quite significant budget costs; and second——

Mr. HILL. But scoring shouldn't be the criterion by which we pick a poor solution over a good solution.

Mr. SUMMERS. But I think the question of whether we are doing something that is diverting resources that could otherwise be used for other purposes, as any kind of tax cut in this area would, that is a different thing than an approach that doesn't impose a cost over time on the Federal Government; and I think it is legitimate to——

Mr. HILL. This is a zero sum game whether we pay for it through private sector reserves or pooling reserves or whether it comes out of losses that insurance companies would take for tax deductions in the future. I mean, over a long period of time, the amount of money to finance the claims ought to be the same; isn't that accurate?

Mr. SUMMERS. Well, I think that there is some potential advantage from relying on the Federal Government's ability to spread risk across space and over time. But I think the tax question is—I mean, we have looked at it a bit, and it is something that should be considered in the context of this issue. But the budget set of issues is one set of issues it raises; the other set of issues it raises goes to neutrality of a different sort. You mentioned neutrality be-

tween corporate-private approaches and State funds. There are also issues of neutrality between insurance companies in this business, and the insurance companies and other financial entities in other businesses who do pay taxes on accumulated interest; and there are apparently, I am told by the technical experts, difficult issues of balance there.

But we would certainly agree with you that the tax issues are something that is appropriate to consider in a full look.

Mr. HILL. Mr. Chairman, if you would indulge me one last question because this, I think, is really important.

You made the comment earlier, your goal is not to have the subsidy, yet in your testimony you talk about spreading the risk over the entire population of the Nation, which really supposes a risk transfer. The question I have is, if we are going to spread the risk over the entire population, shouldn't the benefits of this be spread, likewise, over the entire population? Shouldn't the citizens of States that don't, like my State, Montana, which have a catastrophic exposure in terms of the types of perils they are exposed to, but not the size of the economic risk, shouldn't they benefit equally to the people where there is a concentration of values?

Mr. SUMMERS. I think in terms of speaking about spreading risk, I spoke somewhat imprecisely, and that may be why I wasn't very clear in my conversation with Congressman Kennedy earlier.

We are not—by spreading risk, when I use the term spreading risk, I am not speaking about having taxpayers in one State subsidize taxpayers in another State. Rather, the notion is that the Federal Government can bear risk more inexpensively because of its charge. Just as a life insurance company that insures 100,000 people can price more effectively than a life insurance company that insures only 100 people, even though it is not subsidizing from one person to another and is charging everyone a premium, based on their assessment of that situation, so also the Federal Government, by virtue of its size, has an advantage in bearing risk. But that does not mean that it is engaged in cross-subsidy.

I think the question you get into when you raise—and one can argue this, it seems to me, on both sides. The question you get into when you look at States that have less extreme catastrophes is, on the one hand, I think all of us feel the impulse to provide benefits uniformly and in a nationwide way, and not to buy benefits for some, rather than for all. On the other hand, one of the principles that many of us have embraced here this morning is that the Government should do what the private market can't do, not what the private market is able to do. And for catastrophes of a more predictable sort and of a less extreme and more frequent sort, there is a sense that the Federal Government has much less role in adding value, and that any Federal involvement would be much less additive and much more replacing of what private markets would otherwise do.

So the question that I think the committee will face in drafting legislation is the tension between the goals of universality and the goals of not displacing the private market.

Mr. HILL. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much, Mr. Hill.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Secretary, I appreciate your comments and particularly your comments on the legislation, and I think in hearing the discussion of the Members that we should be cautious today in being concerned about some States benefiting under this program, because there are many other programs that some States benefit from and others do not. So if we start getting into ticking off States, we are going to find out we are going to put ourselves in a jam in the States we represent.

I will give you an example. With the Federal flood insurance program, which doesn't necessarily benefit every State, it is a subsidized program, it is very important to my State, and so I think we should be cautious.

I also think the comments that Mr. Vento made are on point. Again, I would reference the flood insurance program with respect to mitigation. In Houston, Texas, for instance, we have a situation: We have a moving flood plain because we have no land use control, and so you have constant upstream development that occurs, changes the flood plain, and there is nothing we can do about it. But the taxpayers from around the country tend to subsidize.

But the way I see this program, in looking at this legislation, it would appear there is, at least initially, not a subsidy. There may be an implicit subsidy of some part, but not an explicit subsidy. I guess ultimately if everything bad were to happen, that could occur.

But, Mr. Summers, if you could explain further in the technical questions in your appendix, you have three points that I am curious about. One is that Treasury would propose that the Secretary not be able to deviate pricing of premiums downward but only upward, and I guess that addresses in part the rebate question that Mr. Vento raised.

Second of all, the issue of risk load, and then the question of the budgetary impact, is it possible to structure the legislation and to structure the fund in such a way, perhaps, like the BIF fund, where the funds are secure, that they are not used for other purposes, to structure the Secretary's and the commission's pricing so that it reflects the capital adequacy of the fund.

Mr. SUMMERS. My impression is, those difficulties should be surmountable, although in not all of those difficulties could I give you a precise means of surmounting. It is an issue that I think requires very careful political thought.

You mentioned the example of the BIF fund. One of the concerns in this area, given that we are talking about catastrophes that have a very low probability of taking place, is that after 15 or 20 or 25 years, when there has been no catastrophe and the premiums have been paid and have been accumulated in a fund, one senses there is the possibility that since the fund has substantial resources, there might be a feeling it was no longer appropriate to charge premiums; and that, of course, would be wrong because with 1 in 100 events, it would not be remarkable that 25 years could go by without such an event taking place.

So I think we have to think very carefully about what the right mechanisms are for ensuring that that is managed well. And of

course the questions of scoring are questions on which much of the expertise resides up here in the budget process and at OMB, but I think these are manageable issues, but not easy issues.

Mr. BENTSEN. It would seem, in particular with the capitalization of a fund, obviously there are some legislative things we can do to tighten it up to ensure the funds are allocated properly and accounted properly. And I agree that after 25 years, you could have delegations from certain States who might say, well, gee, we haven't had an earthquake in 25 years and now we have paid in the premiums to such an amount that we are way overcapitalized, although you might, I guess, want to look at a formula. Because your risk exposure should be rising as well, hopefully the property values are increased at the same time the fund balances are increased, so you might consider that.

It might be helpful if we do move forward on this legislation—as I guess the Chairman has indicated we are—that Treasury, in the response you are going to provide the Chairman, that you might be willing to provide some specific language or ideas to address that.

Mr. SUMMERS. We will do that.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman LEACH. Well, thank you, Mr. Bentsen.

Dr. Weldon.

Mr. WELDON. Mr. Chairman, I will pass.

Chairman LEACH. Thank you.

Mr. Maloney.

Mr. MALONEY. Thank you, Mr. Chairman.

Mr. Secretary, thank you very much for your testimony, and thank you in particular for your testimony to the effect that H.R. 219 provides a foundation. And I look forward to working with the Treasury Department as that foundation is developed, and the first thing I would do, just by way of comment, is to reinforce Mr. LaFalce's and Chairman Leach's comment that that cooperation on the development of the legislation is very important to us, and we look forward to that.

My question has to do with the mitigation issue. Literally, the old proverb is, an ounce of prevention is worth a pound of cure, and therefore, from a financial as well as a human point of view, I think that the mitigation issue is critical and a critical element of the legislation.

You have expressed what I believe you referred to as "technical concerns" about the mitigation language in the bill as it stands. I would be very interested in an amplification of those concerns, and I would also be interested in the Treasury's view as to any other framework of mitigation. What other things relative to mitigation should the committee take up in its deliberations?

Mr. SUMMERS. Let me, if I could, just make very clear that we very much share your concern, and I think if one looks at the legislative history in this area, rather elaborate mitigation procedures have been very much under discussion and, frankly, have run into a variety of obstacles of practicality and of politics. And I don't have a specific alternative to suggest today.

Our concern was, as I think I mentioned earlier, that if you have the legislation—if you have the funds diverted from the disaster fund, then they are not there in the disaster fund to meet the disaster, and you also change the whole process in the sense that you have appropriated funds and appropriated outlays, and all those kinds of problems seem to us to be large.

But I think in the context of the Federal Government's continuing review of its disaster policies and its impact on building codes and the like, there is a set of things that can be done. And while I don't know that we have any original thinking to offer on that, and it is not really—this part of the issue, frankly, is not something that really falls within the Treasury Department's competence. What I would be happy to do is provide you with some summary of the set of provisions that were under discussion earlier.

Mr. MALONEY. Fine. I just want to take the opportunity to point out that the bill, as it sits today coming out of the subcommittee, is different than the bill going into the subcommittee; and one of the critical differences is that the mitigation funding is, in effect, only available beyond the actuarial soundness of the fund, so the prior concerns about mitigation money coming out and therefore not being available to the corpus of the fund for indemnification is not exactly the situation as it sits in the bill.

Mr. SUMMERS. I think you make a very important point, Congressman Maloney. We still, I think, worry that if you don't provide—if you establish the principle that any part of the accumulation of this fund, either an actuarial thing or a risk load, which covers the prospect that you might not have gotten the actuarial part right, to establish the principle that those funds can be spent, that may be a somewhat slippery slope, and that is why we view it with a lot of caution.

Mr. MALONEY. I understand that point of view, and I think that goes back to something Congressman Vento said, and goes to the whole issue, then, of rebates and other kinds of misuse of the fund; and that goes really to the general issue of the management in finding a way to guarantee the integrity of the management of the fund.

But I would say that that is the direction that I would look to for the solution, rather than not providing an effective financing vehicle for mitigation efforts.

Mr. SUMMERS. I think that is a fair comment. I would not want to dispute that at all.

Chairman LEACH. Thank you very much.

Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

I think the Federal Government has two roles. One is as concerned with its citizens as a Government and concerned with human beings, we should want to reduce disaster losses, make sure those disaster losses that occur are insured, provide Federal aid for uninsured losses, knowing that if we don't provide that aid, the financial loss will have to be absorbed by the same people that absorbed the psychological trauma of the disaster itself.

This bill, I think, goes a long way toward trying to make sure that losses are insured losses, rather than uninsured losses.

I hope we would also be acting to try to reduce and mitigate the risk, but just because a bill doesn't achieve everything doesn't mean it doesn't achieve important results.

The other role for the Federal Government is as the world's largest financial entity. It should be pointed out the Federal Government has OPIC agency, along with a number of others, where it decides to get into the insurance business, in part because it is the largest financial entity in the world and can shoulder risks that various private sector companies cannot, and even earn a profit, in part because it has an interest in making sure insurance is available so as to allow a particular economic activity to proceed.

As I understand this bill, the premiums that will be charged will be actuarially sound and, if anything, may allow the Federal Government to make a profit; and if the Federal Government is nothing more than the world's largest private investor, it might be a good deal. But I think the other thing to point out is, the Federal Government is not just an investor in reinsurance; it also, as a Government, suffers the cost of uninsured losses. And my question goes beyond anything that I would ask the Secretary to respond to orally, because I think it will take some analysis by your department, and that is to take a look at how much the Federal Government has to gain by having more disaster insurance purchased by homeowners.

First, in the area of FEMA and other Federal agencies, what does the Federal Government save by not having to provide as much aid in the upcoming disaster? And then, second—and I know this was alluded to by one of my colleagues earlier—looking at the tax system, where there are substantial tax deductions for those that incur uninsured losses, but if the loss is insured, the homeowner is made whole and the Treasury does not suffer a loss.

What I would propose is that you take a look at the disaster most impressed on the minds of my constituents, the Northridge Earthquake, and analyze, both in terms of the expenditure side, FEMA, and so forth, and the tax side, what would have been the Federal cost if the number of homeowners that had disaster insurance had been 20 percent less than actual; or what would have been the Federal savings, both in terms of increased revenue and reduced cost, if 20 percent more homeowners had purchased disaster insurance prior to that earthquake. And I think we may come to a bill that not only is scored revenue neutral, but is perhaps scored as a—and my guess is CBO would not be this sophisticated—but should be scored as a bill that provides substantial benefit to the budgets of the future.

I have very little remaining time, and perhaps you have a few general comments, but I know this will take an analysis of the Department.

Mr. SUMMERS. Congressman Sherman, you raised a very important set of issues. The tax point you make is not one that I am aware that anyone has thought about, although it seems to me to be a very important point, and we ought to be able to try to make some kind of estimate of the magnitude of it.

The people have looked to some extent on the expenditures side, and there are effects, but I think—and we will study this more carefully in response to your question—that the effects are not as

large as one might at first suppose, that the vast majority of the Federal money after Northridge went for various kinds of improvements in reconstruction of infrastructure, of various kinds of compensation for costs to State and local government entities, and that the amount that went to homeowners to compensate for costs that would have been insured by homeowners' insurance, is—at least from the preliminary looks that have been described to me, these costs are actually not large.

There is an additional potential interaction having to do with a possible—you know, possible public sector roles in the event of insurance company insolvencies, which is an additional interaction that goes in, and I think the general point that you are making, which is that, in part, in the event of a substantial catastrophe, the Federal Government will have very large liabilities; and to the extent it can be compensated in advance for those liabilities, any amount at all that is better than not being compensated seems to us to be a fair and important one, and I think is at least briefly noted in my prepared statement as one of the rationales for Federal Government in this area.

Mr. SHERMAN. About how long will it take for this massive project I have asked for?

Mr. SUMMERS. Oh, we will get it to you as rapidly as we can. I shudder to make an estimate because of a rule I learned as a student, when somebody said to me when an estimate is given of how long something will take, what one should do is double it and move to the next higher unit of time, so days become weeks and weeks become months, and since then I have learned to be careful about giving estimates as to how long things will take, but we will do it as rapidly as we can.

Mr. SHERMAN. Thank you.

Chairman LEACH. Thank you very much.

Did anyone else want to add anything?

If not, let me just say in summary that I have been impressed with the discussion that has occurred. It seems self-evident to me that there is a possibility in the making of a win-win situation, one in which homeowner insurance premiums can be reduced, one in which risk can be removed from parts of the insurance industry, and one in which taxpayers can conceivably actually earn money in a program, rather than lose.

On the other hand, if this kind of approach is misshapen, you could have significant taxpayer liability, and so certainly the details are essential in how we proceed; and for that I am appreciative of the testimony today and the commitment of future input from the Department of the Treasury. Thank you very much.

Mr. SUMMERS. Mr. Chairman, thank you very much and let me just thank you for this opportunity and the Members of the subcommittee, who I think have made a great contribution in bringing this to this point. And I would like, in particular, also to thank the Members of your staff and the Members of the subcommittee staff who have given a great deal of thought to these issues and with whom we look forward to working in the future.

Chairman LEACH. Well, thank you, Mr. Secretary.

Chairman LEACH. I would now like to ask the second panel to come to the table.

Our second panel includes representatives of State-operated catastrophe programs, which would be eligible to purchase the Federal reinsurance envisioned in the legislation. I should mention, at the request of our Ranking Member, Mr. LaFalce, the Insurance Commissioner of New York was invited by the committee to testify, but was unable to attend because of a scheduling conflict.

Mr. Donald Dowdell is Deputy General Counsel of the Florida Department of Insurance and is testifying on behalf of Florida Commissioner Bill Nelson.

Mr. David Knowles is the Chief Deputy Insurance Commissioner for the State of California and is testifying on behalf of California Commissioner Chuck Quackenbush. In 1995, as an assemblyman, Mr. Knowles authored legislation to pave the way for the creation of the California Earthquake Authority.

Chairman LEACH. Gentlemen, welcome.

Mr. Dowdell.

STATEMENT OF HON. DONALD A. DOWDELL, DEPUTY GENERAL COUNSEL, DEPARTMENT OF INSURANCE, STATE OF FLORIDA

Mr. DOWDELL. Mr. Chairman, Members of the committee, thank you very much for the opportunity to speak to you this morning concerning this legislation. What I would like to do is just to summarize pertinent facts based on Florida's experiences, which I think indicate the wisdom of an approach such as is suggested in this legislation.

Hurricane Andrew, when it struck south Florida, caused $20 billion worth of damages, including $16 billion worth of insured damages. Hurricane Andrew is considered to be about a 1-in-50-year event and it was a Category 4 hurricane. Andrew was by no means a worst-case scenario. If the course of the storm had veered one degree to the north, and had made it to the Miami-Fort Lauderdale area, damages would have been about $52 million.

Chairman LEACH. Excuse me, if I could interrupt just briefly. If you would, pull the microphone a little closer. Thank you.

Mr. DOWDELL. Thank you.

As bad as it was, it could have been worse. But following Hurricane Andrew, the damages that we saw caused the insolvency of 11 insurance companies, who were rendered insolvent in whole or in part as a result of their inability to pay claims resulting from that hurricane. Two additional insurance companies, State Farm Fire Casualty and Prudential Property and Casualty Insurance Company were saved from insolvency only as a result of significant cash contributions by their parents.

Following Andrew, the voluntary market for homeowners' insurance in Florida basically collapsed. Insurers who had an overconcentration of risk and sought to secure additional reinsurance coverage were unable to do so. Many insurers sought to terminate all of their existing obligations and leave the State. Virtually no coverage was being written anywhere in the State, including the areas in north central Florida, where the risk is minimal, for new policies.

We passed a law which limited the ability of insurance companies to cancel policies and put a cap of 5 percent on the total num-

ber of their existing homeowners' policies, which could be canceled in any one year. That law remains in effect today.

Despite that statutory limitation, we had to create a residential property joint underwriting association to provide coverage to those insureds whose policies were terminated and also to individuals purchasing new homes.

The population of that joint underwriting association grew to a high of about 930,000 policies in 1996. Through aggressive and innovative depopulation efforts, we managed to get the population back down to a current level of about 339,000 policies. But while we were doing that, the population of a second JUA that provides coverage against the peril of wind only, increased to about 450,000 policies.

One success we have had has been the Florida Catastrophe Fund, which we created in 1993. The fund provides low-cost reinsurance coverage to insurers that are providing homeowners' coverage and other residential coverages in Florida. The premiums paid by those insurers accumulate tax free, and right now that fund has about $2 billion of cash on hand. In addition, as a result of a recent IRS ruling and the CAT Fund's ability to issue assessments to policyholders, they now have an ability to raise about another $8 billion through the issuance of tax free bonds, if those funds are necessary.

Florida has done about everything we can do at this point to deal with the threat of hurricanes, but we are nowhere near able at this point to handle a mega-hurricane. An event of that magnitude would exhaust the current claims paying ability of the Florida CAT fund and the two JUAs and result in an inability to pay all the claims that occurred.

Further, if there were such a mega-hurricane, the funds of those mechanisms would be totally exhausted, they wouldn't have any funds available to pay claims from a subsequent event. While that is not likely in any given year, the models indicate that it will no doubt occur, and the only question is when; and if the claims can't be paid and repairs, not made, mortgage defaults and economic disruption will no doubt ensue.

I would like to point out Florida is not alone in this regard. I have heard testimony and comments earlier. It has estimated a Category 4 or 5 hurricane striking New York, New Jersey, Texas, going in any populated area would cause damages in the range of $40 to $50 billion, and there is similar liability for earthquakes in Washington and also on the New Madrid fault, where an earthquake would cause about $69 billion in damages.

Insurance is founded on principal spread of risk, and the current capacity of the reinsurance industry and the current capacity of any one State is inadequate to be able to effectively spread the risk of loss from truly catastrophic hurricanes.

We support this legislation. We think it is going to give us the ability to handle the 1-in-100-year storm and pay claims, hopefully, and restore some market stability and some stability in pricing. Thank you very much.

[The prepared statement of Hon. Donald A. Dowdell can be found on page 270 in the appendix.]

Chairman LEACH. Well, thank you very much, and we are appreciative of your testimony and we want you to extend our best to Bill Nelson, who is a distinguished ex-colleague. Thank you.

Mr. Knowles.

STATEMENT OF HON. DAVID KNOWLES, CHIEF DEPUTY INSURANCE COMMISSIONER, DEPARTMENT OF INSURANCE, STATE OF CALIFORNIA

Mr. KNOWLES. Mr. Chairman and Members, as the Chairman mentioned, my name is David Knowles. I am Chief Deputy Insurance Commissioner. I serve with Chuck Quackenbush, who is our elected Insurance Commissioner of California.

In order to give you a snapshot of the California experience, I would start by saying that for many years prior to 1994, linkage was public policy in California, meaning to say, there was a mandated requirement to offer earthquake coverage. For every policy of homeowner insurance that was sold, the insurer had to offer to sell a low deductible, frankly very low premium, underpriced policy of earthquake insurance. We didn't know how underpriced it was until the Northridge event, because in the aftermath of the Northridge quake, it was evident there was a fundamental flaw in the way in which earthquake insurance had been written and in which it had been priced.

Two brief examples I will give to quantify: There is a Thousand Oaks-based company named 20th Century Insurance Company which, upon the advice of the best scientists at the time in the early 1990's, the earthquake modelers, in order to protect themselves against risk of loss with earthquake and their book of business, which was centered heavily—overconcentrated admittedly, but centered heavily in the North L.A. County-San Fernando Valley area, the earthquake modelers with the best of science said, you need a $100 million reinsurance policy in order to protect yourself from an 8.0 earthquake on the Richter Scale.

An earthquake came along January 7, 1994, known as the Northridge quake that was 12 times smaller than an 8.0, it was a 6.8 on the Richter Scale event, and 20th Century Insurance Company paid out 10 times the amount of their reinsurance policy. They were barely left standing after that event; by way of selling off various divisions and other creative plans, they are still selling auto insurance in California today.

But the massive degree of overexposure to which companies were subject was becoming apparent. Many companies ended up paying out more in claims in Northridge alone than they had collected Statewide in the last 25 years prior to that for earthquakes.

By this time, our homeowners' market was shutting down because if the price to sell homeowners' was that a company had to massively overexpose itself and risk the 20th Century experience, or worse, they were willing to walk away from the homeowner market. Our fair plan in a 2-year period of time quadrupled in its population. The nonadmitted market was moving in at a premium price that was several times, in many cases, the normal homeowner policy that was available.

It became quite clear there existed in California a strong association between the threats of insolvency to the insurance industry

and the interests of consumers in California. The last thing any of us wanted, regardless of our philosophical strife, was for consumers to have to line up one day to get pennies on the dollar for their losses for which they had paid premiums in good faith; and that is why the Consumers Union came along and sponsored this conservative Republicans' bill known as AB–1366, a mini policy bill which wrote down the coverages, wrote up the deductible from 10 to 15 on the mandated earthquake offer. They, at that time, despite the fact that part of their testimony today says that coverages are not adequate or affordable, thought the coverages were adequate and affordable that they sponsored in that bill, and it became the platform of coverages on which the California Earthquake Authority today is now based, as we work together to go on from allowing the private companies to offer the mini policy with a reduced mandate to offer, as well as creating the authority that you know of today as the CEA or California Earthquake Authority. It is a tax deductible, privately funded, publicly managed entity writing earthquake insurance for Californians. It occupies about 71 percent of our market share, and together with the other 29 that write the private mini policy, resulted in a dramatic and total reversal of market conditions.

I wish I had time to go into greater detail to address Mr. Kennedy's concerns, which he mentioned, about participation. In fact, Californians are buying this product. Between the private market and the CEA purchases we are at pre-Northridge levels. There is always a spike in purchases for catastrophe insurance, notably earthquake in California, following an event; and there was a big spike of about a million extra policies following the Northridge quake for about a year or two, as well, but we are back into the market in full steam.

In summary, I would say the CEA is up and running and has dramatically reversed the problem of constricting homeowner and earthquake markets in California, and we can stand two 250-year probable maximum loss events today. And you might say that is great and sufficient protection, but we believe that H.R. 219 proactively sets up a Federal reinsurance pool to protect homeowners nationwide against the loss of their homes to inevitable natural disasters; and it is a farsighted measure that addresses this critical issue before a disaster hits, rather than attempting haphazard recourse after the fact. We will greatly extend what we can do for our consumers in California, and we will greatly improve our ability to protect them and extend coverages to them in the years to come. We are here in support of moving the bill forward.

[The prepared statement of Hon. David Knowles can be found on page 279 in the appendix.]

Chairman LEACH. Let me thank you very much, and also if you would give our best to Mr. Quackenbush, who testified before us about a month ago and who is playing such a lead role on the Holocaust issues, among others.

I think it appropriate to introduce our new brain trust that has joined this committee. This is a daughter and best friend, who is also a daughter for the day, and we expect to learn a great deal from all age groups' perspectives. They indicated that their father is not talking relevant issues and that brought before the commit-

tee should be the question of whether a report card should be issued or not.

In any regard, I thank you all.

Let me ask Mr. McCollum if he has any questions.

Mr. McCOLLUM. Thank you, Mr. Chairman.

Let me ask you about Florida's participation in any of the programs contemplated: H.R. 219, as it now stands, or possibly modified, as Secretary Summers indicated he desired, by a certain excess-of-loss contract opportunity. How would the State of Florida finance any purchase of whatever premiums and whatever protection was purchased, be it directly into the fund that is contemplated by H.R. 219 or through an excess-of-loss contract?

How would you finance that purchase? Would the cost of that be passed on? Would the CAT fund itself retain the cost to absorb it? Would the insurers be required to line item to the public in buying a policy, X amount of this cost is now passed on to you, and here is the extra price for that insurance premium? How would it be financed?

Mr. DOWDELL. Congressman, there's any manner of ways it could be financed. What I can say for certain is the way the bill is structured, it gives us flexibility. There is no question in my mind that the coverage afforded by the CAT fund can be coordinated readily with the reinsurance program and its ability to purchase reinsurance, which is described in this legislation.

Legislation, I suspect, would provide for the cost of that layer of reinsurance to be built into premiums and included in the premiums paid by policyholders; that is how we currently recoup the CAT fund premiums and the other residual market premium payments.

Mr. McCOLLUM. So that would be included in the premiums that policyholders pay, "policyholders" in this case being individual homeowners, as opposed to the insurance companies; is that correct?

Mr. DOWDELL. That is correct.

Mr. McCOLLUM. Would Florida be prepared to bid on an auction if an auction market were created, be that for the CAT fund directly or into the H.R. 219 system; or be that on excess-of-loss contracts, if they were a mechanism?

Mr. DOWDELL. Congressman, I know that the auction mechanism that was originally proposed last year, we had some serious reservations with that; and I know there have been some modifications to that in this bill. I really couldn't say at this point. We have only had the bill a short period of time. We haven't had a chance to analyze that.

I don't think we would have a need to—basically, I think, with the reinsurance program that is there, that would just provide a layer of coverage above what the CAT fund is already providing, and between the availability those funds and the CAT funds, we would be able to handle virtually any event.

Mr. McCOLLUM. Mr. Knowles, in California your system works differently than Florida's system, quite a bit. Does that make you more or less comfortable with the precise version in H.R. 219, or does it meet your needs too because it is tailored that way?

Mr. KNOWLES. We are not comfortable with the precise version of what we see presently, and therefore I am excited about what the Treasury Department is going to do to join together with many of you to work on language to go forward from here. Quite frankly, if I may be so bold to suggest it, both I and the commissioner, Chuck Quackenbush, feel that the best long-term solution to the problem that we face, notwithstanding the wonderful efforts that you gentlemen have gone to to try to erect a solution here, is simply tax-exempting the accumulation of reserves or catastrophes by the private sector, by private companies.

Europe does it. It works. It takes a long-term view of protecting its citizens from disaster, and I believe this Nation ought to do it as well and reflect it in our tax policy.

However, in the meantime, talking about political reality and what is achievable, we laud your efforts and we look for some marriage of the ideas to come together, and that is why we are here supporting the concept.

Mr. MCCOLLUM. Well, I appreciate your frankness about it. I certainly support changing the tax laws of those reserve funds as well, but you are absolutely right about the practical problems of doing that with regard to the moment in Congress, balancing the budget, and so forth.

So we are here trying to modify this bill in a way that will be acceptable to you and to Florida and to the other States involved. We are just needing your guidance on how to do it. And as I think the Chairman indicated earlier when Secretary Summers was here, any specific legislative changes, any language, you don't have to write a whole bill for us, but either Mr. Dowdell or Commissioner Knowles, either one of you in your respective States suggesting to Mr. Lazio, myself, Chairman Leach, specific lines that you think and ideas you think might help improve this bill, I presume—I don't want to presume for Mr. Lazio, but I think we both would be welcoming those suggestions if you have them.

I want to thank both of you for coming today.

Our States, Florida and California, are greatly in need of some form of protection for capacity for insurance and for ways that will help if we have two events or the "big banana," as they say in California, happening.

Mr. KNOWLES. Thank you, Mr. McCollum and Mr. Lazio for both of your efforts in this area and specifically for welcoming us to participate in suggesting language. We will do our best to be supportive and prompt in that effort.

Mr. MCCOLLUM. Thank you. Thank you, very much.

Thank you, Mr. Chairman.

Mr. LAZIO. Mr. Vento.

Mr. VENTO. I will yield to Mr. Sherman.

Mr. LAZIO. Mr. Sherman.

Mr. SHERMAN. Thank you.

Mr. Knowles, it is always good to see a representative from the California State government here in Washington.

Mr. KNOWLES. Yes, sir.

Mr. SHERMAN. As I understand it, the CEA now purchases reinsurance for, is it $2.5 billion?

Mr. KNOWLES. That is correct, just below $2.5 billion, and it has a claims paying capacity of $7.4 billion, but the reinsurance component is $2.5 billion.

Mr. SHERMAN. Now, the other $5 billion of, quote, "paying ability," you are not sitting on $5 billion in cash that you and Chuck can kind of roll around in?

Mr. KNOWLES. You know, that would probably be nice in a more perfect world, but that is not the case.

Mr. SHERMAN. Where does the rest of the paying capacity come from, if it is not sitting there in cash?

Mr. KNOWLES. The rest of it comes primarily from contingent liability to the participating companies. In the event of an earthquake event, that would be of a certain size, and depending on how big and how many insured losses were covered in that event, they would be assessed perhaps billions of dollars.

Mr. SHERMAN. And you said the CEA can now handle two 250-year events?

Mr. KNOWLES. That is correct, and together with the change of going from the historic 10 percent deductible up to the 15 percent deductible that is present in the private industry policies as well as the CEA coverages, getting rid of swimming pools, rented structures, Norman Rockwell china, not covering those, the combined force of that indicates that today we could withstand, with the CEA claims paying capacity, a full three Northridges.

Mr. SHERMAN. So in terms of trying to make the system better for consumers, it would be nice if you could handle four Northridges, but three seems sufficient. I don't know anybody who thinks that earthquake insurance in California is a good deal. I mean, there are people who buy it, but they are always complaining about it. And part of the cost is what you are paying for reinsurance. As I understand it, you are paying 10 times actuarial cost and more in order to get that reinsurance. If the Federal Government went into the reinsurance business, how much would you hope to save?

Mr. KNOWLES. Well, it is interesting that you would use a figure of 10 times actuarial cost. I am sure someone went to great efforts to prepare a number like that. But what is an actuarial cost and what isn't an actuarial cost, one of the best guides that I have used and that I have seen used over the years is not only actuarial, what we know of actuarial science *per se*, but also what the market finds necessary to charge for it; and we are paying 11 and 14 percent respectively for various layers of reinsurance, in and through the CEA. As to whether that is 10 times the actuarial cost, there wasn't anyone else to offer it at any price and this is the first time in history a reinsurance commitment of this magnitude has been made for reinsurance specifically.

Mr. SHERMAN. So when you say 11 percent, for example, you are saying to get $100 million worth of reinsurance coverage, you are paying $11 million per year?

Mr. KNOWLES. That is right.

Mr. SHERMAN. You have looked at the statutory language before us. We passed this bill. Any guess as to what you would be paying the Federal Government for reinsurance, and do you think it would

be between 11 and 14 percent or closer to the 2 percent that we have heard earlier?

Mr. KNOWLES. I think it would be closer to the 2 percent that we heard earlier. You know, I have not studied it to the point where I could say that it would be 2.9 or 1.8, but I think that it would be closer to the 2 percent that we heard earlier. And we have a situation here where there is no other entity available that we know of on this planet to offer that kind of capacity and to frankly provide to Californians these additional layers of capacity that could take from us the $7.4 billion claims-paying capacity all the way up to perhaps $25 billion.

Mr. SHERMAN. So, Mr. Knowles, this bill is going to save California consumers or the CEA, and hopely indirectly California consumers, a couple-hundred-million-dollars every year. Are you wildly in favor of this bill?

Mr. KNOWLES. I would not characterize my emotions or the commissioner's as being wildly in favor of the bill. We are wildly in favor of the concept of the Federal Government playing a role, because as you know, Congressman, California consumers—and again, the CEA is populated today by 955,000 policyholders, in addition to an entire segment of the market that is not non-CEA. There are a lot of people interested in protecting themselves to the point of they are putting out hundreds of dollars a year to buy earthquake policies, and they feel that they have done their part, and they feel that the State government has done its part.

It was cathartic, frankly, to bring two-thirds of both houses together around that CEA bill, I'll tell you. And now, frankly, a lot of us look to the Federal Government, not necessarily to open the storehouses of the Treasury, but in a wise and productive and deliberative manner, as these gentlemen have let, to execute its role in this matter as well.

Mr. SHERMAN. I think you deserve praise for creating the CEA in Sacramento, and certainly a $200-million reduction in the cost to California consumers will cause a lot of my people in my district, for example, to actually buy the insurance and stop being as nervous as they are not wanting to overpay and at the same time not wanting to go without coverage.

Thank you, Mr. Chairman.

Mr. LAZIO. Thank the gentlemen.

We have a vote that is on right now, but we do have a few more minutes.

Do we have any questions. Mrs. Kelly.

Mrs. KELLY. Yes, thank you, Mr. Chairman.

I do have a question. I have listened to your testimony, and I can see from your testimony what your funds can handle, but we are talking about Federal legislation here. And I want to know what your estimate of the level is about where you think that the Federal Government ought to be stepping in. What number are we talking about in terms of where you think the Federal Government ought to come in? Do you have any thoughts on that?

Mr. DOWDELL. As I understand, the way the bill would operate as currently written, there would be a layer of up to $25 billion above whatever the State's retention was. And right now Florida has got about a capacity of $10 billion; it will be around $11 billion

by around the end of this year. I would think in order to be able to have reinsurance coverage for a mega-hurricane, the ability, if we need it, to be able to get up to that level is about right.

Mrs. KELLY. Would you definitely buy the Federal insurance that was at the end of the plan in H.R. 219?

Mr. DOWDELL. I couldn't say that we would definitely buy it. My expectation would be that, yes, we would, assuming that it was priced appropriately, because our experience, I think, has been like many others'. Reinsurance has been unavailable, or to the extent it is available, it has been unaffordable.

Mrs. KELLY. What about you, Mr. Knowles?

Mr. KNOWLES. I think the answer to your first question is that that amount has got to be different for different States. The different States are insuring different risks, have different population sizes, have different numbers of insureds in their books of business. And the very nature of the risk of their insuring can cause more or less damage to structures. So I think that it is something that as we work through the specific language of the bills, those attachment points have got to be specified for the various structures that this would provide—that the Federal pool would provide a reinsurance layer to.

Mrs. KELLY. Mr. Knowles, do you consider the cost of reinsurance that is currently available too high?

Mr. KNOWLES. I would consider it too high when I am buying, and maybe not high enough when I am selling, depending on what side of the table you are on. And, you know, these guys have got to stand up to all of those claims one day, if we walk in and have that event. So that is the $64 billion question sometimes, isn't it? The point is that I believe that it can be done on a more frugal scale. Right now it is working for California.

Mrs. KELLY. So you think it is a rip-off?

Mr. KNOWLES. It is working for California. And, you know, there was no one else to step up to the plate and offer us that kind of coverage for that kind of price, as far as the reinsurance layer goes. It was the first time ever in history that this kind of package was put together to insure these kinds of risks, particularly in this magnitude. So we are thankful for the structure, for the presence of the reinsurance layers being there at this price, and it is working. We think that we can actually improve on this recipe.

Mrs. KELLY. Just one quick thing. I want to know what mechanisms you have in place to continue funds if you exhaust your resources. What have you got to continue the funds if the resources for them are exhausted, anything in place?

Mr. DOWDELL. We do not have anything in place, and that is why we support this legislation. It would enable us to be able to avoid exhausting the available funding and funding mechanisms we have,.

Mrs. KELLY. Thank you, Mr. Knowles,.

Mr. KNOWLES. Similarly, if there is in California a huge earthquake that we have never seen before, or a series of earthquakes, it would quickly deplete CEA claims-paying capacity. The statute calls for claims to be out of that point on a pro-rata basis, and for the closure of the authority. So there is no contingency plan beyond that, and that is where we are looking to the Federal Government

to perhaps have some sort of partnership role. And that is why we are here in support of H.R. 219 today.

Mrs. KELLY. Thank you very much.

Thank you, Mr. Chairman.

Mr. LAZIO. Thank the gentlelady.

We have eight minutes left on this vote. I am going to hold the hearing in recess until 1:15, and we will come back about 1:15 for the remainder of the questions. The hearing is in recess.

[Recess.]

Chairman LEACH. Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. And I want to thank both of the panelists, Mr. Dowdell and Mr. Knowles, for their knowledgeable and thoughtful testimony.

I guess what I would like to discuss, because of the creation of three State programs, the liquidity problem in California, Florida and Hawaii as a result of recent natural disasters.

I would like to ask your assessment of their reinsurance capacity in each of your particular regions. I think it is probably important to think about reinsurance, not just in terms of having national availability, but availability for a particular region and this so-called "risk-of-ruin" issue that is very much inherent in the pricing of reinsurance. I would ask Mr. Dowdell first, what, in your opinion, is the capacity of private reinsurance right now in the Florida marketplace?

Mr. DOWDELL. Congressman, our experience has been that the reinsurance has not been readily available that is required in order to adequately spread the risk of loss from a truly catastrophic hurricane. I think that is probably a result of two things: One, the demand is for the upper levels. I mean, prior to Andrew, all the models said the maximum losses would be about what they were in Hugo. Now they realize that is wrong. The models have all increased dramatically, and everyone is scrambling to get those layers of reinsurance for the truly catastrophic loss, and there is just not enough capacity to assume that amount of exposure.

Mr. LAZIO. I take it if there were more reinsurance, you would buy it if it was affordably priced?

Mr. DOWDELL. That was the other point I wanted to make. If we could have gotten it, we wouldn't have needed to establish the CAT fund, but it was unavailable, and we, as a result, had to establish the Florida catastrophic fund to provide that layer.

Mr. LAZIO. The CEA purchases private reinsurance. I am just talking about some of the pricing issues, and I take it that would be true as well with the California Earthquake Fund, that if there was more affordable reinsurance, that you will be buying it, it would be in the marketplace?

Mr. KNOWLES. It would have to translate either into additional coverages that we are not able to offer today, lower-rated premium, more consumers being able to be covered by the CEA, or some combination of the above.

Mr. LAZIO. So you have reinsurance that you buy. It is all from one entity?

Mr. KNOWLES. No, it is from several different entities.

Mr. LAZIO. No. The number I received, and I am not sure if it is accurate or not, was that an annual premium was approximately $460 million for about a billion-and-a-half dollars of reinsurance. Is that accurate?

Mr. KNOWLES. Unfortunately, the more handsome guy that was sitting behind me has left to catch a plane. He is the CEO with the California Authority. He could tell you with precision, but your number sounds right. I am informed that is closer to two years' premium than one year's premium.

Mr. LAZIO. So it is a very costly undertaking, in your opinion, because of the so-called "risk-of-ruin" that needs to be built into pricing by reinsurers making it virtually unaffordable to buy more reinsurance?

Mr. KNOWLES. It becomes prohibitive to try to put together a structure through solely reinsurance placements, as well as, you know, one has to contemplate is there the willingness on the part of the reinsurance industry and, therefore, the capacity to make such extensions of risk.

Mr. LAZIO. I take it it is sort of self-evident, again, that if the insurance was available, and premiums were not so costly, you could pass on those savings to individual homeowners in the form of lower deductibles or lower premiums?

Mr. KNOWLES. That is true, and obviously the CEA is operated as a nonprofit, tax-exempt entity. However, far be it from me to criticize the reinsurance industry for the price at which we have reinsurance available in California. At this point we are glad they are there.

Mr. LAZIO. It is what it is.

Mr. KNOWLES. If we can grind them down, we will grind them. I am glad they are there.

Mr. LAZIO. One of the points here in terms of the capital markets going to individual reinsurers who have this risk of ruin concept built into the prices are not in the position to offer sufficient levels of reinsurance at affordable prices that make it useful for you to shift risk, to offer risk policies to individual residential owners?

Mr. KNOWLES. I am not sure I caught the import of the question there.

Mr. LAZIO. The point is that the bottom line is that reinsurers have limited capacity right now, a fraction of the potential risk in a State like Florida or in a State like California. There is enormous room to grow in terms of the current State funds and the ability to offer more reinsurance, and the problem really is a dual problem; one of reinsurance capacity overall, and perhaps, more importantly, more efficient pricing for reinsurance contracts. Is that a statement that you would agree with it?

Mr. DOWDELL. It is a statement I would agree with, Congressman. Insurers can only buy reinsurance with the premium that they obtain from the policyholders. It has got to be built into the rate. And at some point in time when the insurance is inappropriately priced, it is effectively unavailable.

Mr. LAZIO. Thank you very much.

Chairman LEACH. Thank you very much, Rick.

If there are no more questions for these witnesses, let me thank you very much. You have got a long way, and you represent the

two States that are most affected, and your presentations will be taken seriously by this Congress. Thank you both.

Mr. KNOWLES. Thank you Mr. Chairman, Members.

Mr. DOWDELL. Thank you.

Chairman LEACH. Our third panel will begin with the background of existing State insurance programs and a description of exactly how the legislation would complement State efforts. The panel will continue its testimony from executives from both small and large insurance companies and will conclude with testimony discussing private market capacity and other capital market solutions to catastrophe exposure.

Mr. Kevin Campion is Senior Vice President of Paragon Reinsurance Risk Management Services, Inc. Mr. Campion has directed the services which Paragon has provided to the Florida Hurricane Fund since its inception in 1994. Since 1990, Mr. Campion has also been actively involved in mechanisms to provide reinsurance to residual markets and governmental entities.

Mr. Joel Freedman is a Senior Vice President and Director of Government Affairs for the Hartford Financial Services Group.

Mr. Robert Pike is Senior Vice President, Secretary and General Counsel of Allstate Insurance Company. Mr. Pike is a member of the executive committee and former Chairman of the board of Governors of the National Association of Independent Insurers and has previously testified on behalf of the insurance industry and before both Federal and State legislative bodies.

Mr. Rade Musulin is Vice President and Actuary of the Florida Farm Bureau Insurance Company. Mr. Musulin worked closely with Senator Stevens during his consideration of disaster legislation in the previous Congresss.

And Mr. Roger Joslin is Chairman of the Board of the State Farm Fire and Casualty Company, Director and Senior Vice President of State Farm Mutual Automobile Insurance Company, and a member of State Farm Life Insurance Company. Mr. Joslin also serves as Chairman of the board of the National Disaster Coalition and Chairman of the board of the Insurance Information Institute.

Ms. Sylvie Bouriaux is group manager of research and product development of the Chicago Board of Trade. And Ms. Bouriaux's group focuses on the development of new products in the equity area and in the insurance and real estate market.

Mr. Frank Nutter is President of the Reinsurance Association of America. REA is a nonprofit trade association of domestic property and casualty reinsurers. Mr. Nutter is Chair of the National Natural Disaster Coalition, an effort to develop a program to respond to catastrophic earthquakes, hurricanes and volcanic eruptions in the United States.

Ms. Isolde O'Hanlon is a Managing Director of the Global Insurance Division, Chase Securities, Inc. Ms. O'Hanlon directs the development of products and services to assist the insurance industry in managing its exposure to catastrophic property risk.

And finally, Mr. Jack Weber is President of the Home Insurance Federation of America. Mr. Weber is a recognized expert on disaster and insurance issues, has participated in numerous forms, and has also appeared before several committees of the Congress.

Welcome to you all.

Chairman LEACH. Mr. Campion, we will begin with you.

STATEMENT OF KEVIN T. CAMPION, SENIOR VICE PRESIDENT, PARAGON REINSURANCE RISK MANAGEMENT SERVICES, INC.

Mr. CAMPION. Thank you, Mr. Chairman.

As mentioned, I am a senior vice president with Paragon Reinsurance Risk Management Services in Minneapolis, Minnesota. Paragon is a wholly owned subsidiary of E.W. Blanch Holdings. We are a leading provider of risk management services. My roles with E.W. Blanch include Paragon's efforts for the Florida Hurricane Catastrophe Fund, for which we provide administrative and actuarial consulting services. Paragon was asked by the Subcommittee on Housing and Community Opportunity to model the structure and vision of H.R. 219.

I would like to briefly describe now what H.R. 219 would do. It would create a Federal reinsurance backstop above State disaster programs and auctions. Federal reinsurance coverage would not begin for any State until that State incurred insured residential losses that exceeded that State's retention or deductible, if you will. Those retentions would be set to be the greater of $2 billion or a magnitude of a 1-in-100-year loss for that State, so a loss with the probability of 1 percent or less. Premiums would be collected for each of these States, and they would be actuarially based. These rates would be set by a new National Commission on Catastrophe Risks and Insurance Loss Costs and would be at least two times the annual expected average loss for those States, plus expenses.

The Loss Costs Commission would also set an actuarially determined minimum or reserve price for any of the auctions, for those States.

Let me now elaborate on the State auction concept and illustrate how it might work using a hypothetical example. Suppose that South Carolina were to create a State-operated auction program, and let's assume that the Loss Commission determined that South Carolina must pay $200 million for the $25 billion of Federal coverage provided in H.R. 219.

South Carolina may auction that limit off in 10 separate contracts, each for 1/10th of the total limit. If the State collects more than the $200 million that the Loss Commission said was actuarially sound, then 90 percent of any excess from that auction would go to the Federal Disaster Fund and 10 percent, or $1 million, of that would be retained by the State for loss mitigation purposes. Of course, the initial $200 million would also go to the Federal Disaster Fund. If then a hurricane were to strike South Carolina and losses were to exceed that retention by a billion dollars, each contract would be worth 1/10th of that $1 billion, or $100 million.

So each company owning one of those contracts would receive $100 million if they had insured losses of $100 million as well. For both the backstop over State programs and the auction, Federal liability would be capped at $25 billion per year after a four-year phase-in period. The liability during that phase-in period would be determined by the Secretary of the Treasury.

Now, let me address two questions regarding pricing and operational issues. The first is, would the pricing for these coverages be adequate? It would be the responsibility of the Loss Costs Commis-

sion to assure that the rates were actuarially sound, and I believe the catastrophe models today could be used effectively to develop adequate rates, especially when you add a risk load equal to 100 percent of what the expected price for loss is. That means that average losses could be twice as large or twice as frequent as the modeling would suggest and the premium would still be adequate. The simulations of this bill that I will discuss later also supports this claim.

Another question is, would this type of a mechanism be operationally feasible? Already three States that account for 20 percent of the U.S. population, including the two States with the largest national hazard exposure, have successful State programs. As a reinsurer, the Florida Hurricane Catastrophe Fund has already dealt with issues similar to those which would be addressed or faced in the implementation of H.R. 219, and our experience with them makes me feel that these issues could be resolved.

Finally, let me describe the work that Paragon did to model this legislation. In this effort we relied exclusively on the results of the risk analysis performed by Risk Management Solutions, RMS, of Menlo Park, California. Their work is used by more than 300 insurers, reinsurers and financial companies worldwide, including FEMA and the National Institute of Building Standards.

Paragon took the losses produced by RMS and developed a computer model to simulate what the Federal reinsurance program based on H.R. 219 would do. Basically what the model does is walk through ten year simulated periods during which the premiums go into the fund, losses are paid out of the fund, and interest is either earned or paid on the balance of the fund. Loss events for each year were simulated using a Monte Carlo statistical method for hurricanes in the Atlantic and Gulf Coasts and in Hawaii and earthquakes in California, the New Madrid fault zone and the State of Washington.

We analyzed how the Federal program would likely perform over this 10-year period under three different scenarios. The first was be only for States that currently have State funds, those being California, Florida and Hawaii. For the second scenario, we added three additional States with high catastrophic exposure and that have considered State programs, New York, Louisiana and Texas.

And in the final scenario, we included all 25 States with significant hurricane or earthquake exposure. We then simulated ten-year cash flows to that Federal reinsurance structure. And we did it for each scenario 50,000 times. So said another way, each scenario analyzed the effects of hurricanes and earthquakes over a 500,000-year period according to the probabilities of the RMS modeling.

The results were as follows. As you can see in the chart over to my right, the average surplus in the program at the end of ten years, of each of these ten-year periods was $5.7 billion for the first scenario in which Florida, California and Hawaii participated.

If you were to add New York, Louisiana and Texas, the ten-year average rose to $7 billion, as you can see in the green bar over there. If all 25 States were to have joined, the modeled surplus would climb to $13.3 billion. And I think these results are somewhat intuitive, in that if the program collects twice what the actu-

arial premium is, the more States to join, the larger the premium and the larger the surplus would be expected to be.

With regard to losses to the program, the programs sustained no losses in 95.7 percent of all years under the three-State program and 88.5 percent of the years in the 25-State program. The likelihood that the program would require a loan from the Federal Government to cover any shortfall in any single year over that 10-year period ranged from 2.4 percent for the three-State scenario to 3.1 percent for the 25-State scenario. So said another way, you would not expect a loan for a three-State scenario except for once in 40 years, and then once in 30 years for 25 States.

And I am pleased to be able to testify here, and I would be happy to answer any questions. Thank you.

[The prepared statement of Kevin T. Campion can be found on page 285 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Campion. And let me say, without objection, all of your full statements will be placed in the record.

We have a problem with another vote on the floor, but there may be several during the day, and so what I would like to do is recess, pending this vote, and then we will return probably in about 12 to 14 minutes. And then we will proceed to Mr. Freedman. And so the hearing is in recess pending the vote.

[Recess.]

Chairman LEACH. The hearing will reconvene. Our next witness is Mr. Joel Freedman. Joel, please proceed.

STATEMENT OF JOEL FREEDMAN, SENIOR VICE PRESIDENT, THE HARTFORD FINANCIAL SERVICES GROUP

Mr. FREEDMAN. Thank you, Mr. Chairman. My name is Joel Freedman. I am a senior vice president at The Hartford. The Hartford is one of the Nation's oldest and largest insurance company. We are possibly the fifth largest property-casualty insurance company and the seventh largest property insurer.

Of course, my written statement was filed yesterday, and I would like to respond. Rather than respond to technical points, let me just see if I can transport people in the audience and the Chairman into the future for a second.

On September 23rd, in the year 2000, at approximately 1:50, exactly 29 months from today a massive category 4 hurricane will slam into the Florida coast at Miami Beach. The wind speed at the time of impact will be 150 miles per hour.

Chairman LEACH. Sorry to interrupt. We have some sightings that we will be testifying later. But please proceed.

Mr. FREEDMAN. Thank you, Mr. Chair.

Chairman LEACH. And you work for what company?

Mr. FREEDMAN. The Hartford. As you'll see, Mr. Chairman, some correlation——

Chairman LEACH. The world wants to insure in Connecticut and not Iowa? But please, proceed, thank you.

Mr. FREEDMAN. As I said, my written remarks have a little more foundation to it.

Chairman LEACH. Fair enough.

Mr. FREEDMAN. Tornadoes will be spawned inland reaching velocities of up to 200 miles an hour and will be as severe as the tragic ones we have seen this spring. Lives will be lost. Thousands upon thousands of houses will be destroyed, automobiles and other personal property will be ruined. Schools and work places will be leveled or impaired, interrupting education, employment for hundreds of thousands of Floridians.

The economy of south Florida will be simply devastated. Emergency workers and claims adjusters will speed to the region's rescue, but the magnitude of the damage will be over three times that of Andrew. Adjusters will move through the rubble and downed power lines to view the damage and issue checks.

But the region will be slow to recover, with people displaced from their homes, schools and businesses and work. Every industry from banking to utility to food services will feel the brunt of the storm, and every small or large business will suffer.

Let me deal only with the impact on the insurance industry. Insured claims of $50 billion will profoundly impact the property-casualty industry. This U.S. industry covering personal and business risks throughout the world has capital approximating $300 billion. Since State and Federal law effectively precludes us from building catastrophic reserves, we will have to reach into our net worth.

Now, while this in itself may not sound earthshaking, the aftershocks will be serious. Some companies will disappear. Others will be significantly impaired, depressing their stock and return to shareholders, both individual and institutional, such as pension plans. Most will be forced to sell assets quickly to cover claims, forcing the financial markets into a tailspin. On top of direct claim payments to their own customers, surviving companies and their customers will have to pay assessments to the various Florida insurance pools.

These financial aftershocks will not be confined to the insurance industry. The impact of the tragedy will be felt in every State where business and individuals depend upon insurance, such as Iowa, where State and local governments require debt financing and where insurance companies are located.

Chairman LEACH. Excuse me, if I could interrupt, since you have referenced my State. We have a larger insurance industry per capita than Connecticut, but please proceed.

Mr. FREEDMAN. Thank you, Mr. Chairman. But I believe that Connecticut has more property-casualty insurance companies.

Chairman LEACH. I am sure of that. Excuse me.

Mr. FREEDMAN. And that is perfectly OK.

Chairman LEACH. I am confused, which set of insurance companies are more profitable over the last decade? Is it Principal or an insurance company in Connecticut? Please proceed, I am sorry.

Mr. FREEDMAN. Is that a question, Mr. Chairman?

Chairman LEACH. I might just at this point, because there are so few Members present, give you all an IQ test. And the test is very simple. What State has the most progressive laws to locate insurance companies in?

Mr. FREEDMAN. That is Iowa.

Chairman LEACH. Thank you. I raise this just because some of you were thinking of expanding and relocating, and it is just a fair question. But please proceed, Mr. Freedman.

Mr. FREEDMAN. As I am sure you know, Mr. Chairman, the Iowa Commerce Department and Insurance Department have been particularly aggressive in the past decade or so visiting probably all the companies in the audience and at the table today, and they have been very successful.

Chairman LEACH. We also have statistics showing what States' work productivity are the highest in. Please proceed.

Mr. FREEDMAN. Thank you. Even States which may be immune to national disasters could likely experience availability and affordability issues. Connecticut, where one of every six jobs is dependent on insurance, and which may have fewer jobs than perhaps Iowa, but it is still the most insurance dependent State, will see its economy crippled.

This prediction is hardly the pulp of science fiction writers or mystics. Dozens of scientists, meteorologists and seismologists have predicted an event of this magnitude just described or similar catastrophes from other States, such as California, New York or Missouri. Remember, we can expect a hurricane with wind speeds the size of Andrew's once every seven years, and the earthquake with the intensity of Northridge every ten years.

My industry colleagues on the panel know it, and most of the people in this room know it; what we don't know is where and when it will occur. The test will be if Congress acts before nature does. While we could do a little to deter the event itself or the loss of lives and much of the havoc, Congress and State legislatures can minimize property damage through improving building standards and enforcement and incentives for property owners.

More importantly, this committee and the House can follow the lead of Congressmen McCollum and Lazio, as well as your late colleague, Bill Emerson, to provide a Federal backdrop for States and insurers seeking to write in those States. No State, not even our largest, has the financial and insurance capacity to meet the challenge of the storm or earthquake I've described. But working within the elements of H.R. 219 and the concepts of H.R. 230, the States will be more readily positioned to weather the storm and insurers will be more willing to provide long-term protection in catastrophe-prone areas.

And I am heartened today by the testimony of Secretary Summers. He agrees with both the gravity of the situation and the need to marry the best features of both H.R. 219 and H.R. 230. Now, detractors will allege today or perhaps allege that insurance catastrophe predictions are too alarmist. It is somewhat ironic that we rely on computers to fly us in airplanes, manage our financial world and run our Government, but not to predict disasters.

Others will suggest insurance and reinsurance is presently plentiful and affordable in catastrophe-prone areas. If so, we would not be here today and insurance regulators, such as those in Florida, would not be seeking to roll back our rates. Still others will claim that these two proposals are no more than Federal bailouts for California, Florida and Hawaii, and property insurers. But the beauty of the proposals is that they unfold a Federal umbrella at

no cost to the Treasury over the long term while shielding the economy from the events I previously outlined.

In summary, The Hartford's twin objectives have been flexibility and action. We have been willing to work with anyone in the Congress or in the industry to develop a catastrophe proposal and applaud the committee's progress. So far the disasters I described earlier will occur, the only question is where and when, and the time to act is not the question, it is now.

Thank you, Mr. Chairman.

[The prepared statement of Joel Freedman can be found on page 276 in the appendix.]

Chairman LEACH. Well, thank you very much Mr. Freedman.

Mr. Pike.

STATEMENT OF ROBERT W. PIKE, SENIOR VICE PRESIDENT, SECRETARY AND GENERAL COUNSEL, ALLSTATE INSURANCE COMPANY

Mr. PIKE. Thank you, Mr. Chairman, my name is Bob Pike and I represent the Allstate Insurance Company, which is the Nation's largest publicly traded property and casualty company, domiciled in the State of Illinois.

At the outset, I think I would like to acknowledge certainly Congressman Lazio, Congressman McCollum and Congressman Fazio. They have provided the bipartisan leadership that brought us here today. This has been an arduous journey. It is one for me that started eighteen years ago.

At that time, I participated in an insurance group of mainly academic types who tried to probe the possibility or probability that the insurance mechanism, its private sector, could not respond to the truly catastrophic effects that some natural disasters can occasion. Those eighteen years of meetings and many iterations of cost modeling, statistical analysis, compromise and consensus have brought us here today.

I resurrected my notes from eighteen hears ago, and I looked at them to see what were the basic principles that we academic types and legal types and actuarial types thought was important if we were going to have a national comprehensive program that really could respond in the event of a mega-disaster, one that could save both the social and economic infrastructure, not only of the insurance industry but, more importantly, of the communities that are so devastated by such a disaster.

They were as follows: One, that the Federal program should be one that included very limited Federal involvement; two, that it had to be a financially sound, actuarially based, prefunded system of financing the Federal portion of the role in order to minimize, if not reduce, the total cost of the taxpayer; three, it had to preserve and enhance the private marketplace; and four, it had to help both the availability and the affordability of homeowners' insurance.

I think if I can provide any perspective, it is not on the technical side, although I was Chairman of the task force that was appointed in California that led to the creation of the CEA, the California Earthquake Authority. I worked very closely with both the Chairman of the Insurance Committee in the Florida House and the in-

surance commissioner in the establishment of the Florida Catastrophe Fund, as well as legislation that is currently being considered. But my perspective, I think, would be more useful to the Committee if I identify some of the myths and misconceptions that have arisen over this particular bill, H.R. 219.

Congressman LaFalce today suggested, and he was very correct to do so, that the history of the insurance industry is to suboptimize both our political and economic influence to the extent we have any. Yet, those who say that the insurance industry is divided on H.R. 219 are in error, I believe. The homeowners' insurance industry, most of which are around this table—small companies from the farm bureaus, large companies like ourselves, and the insurance agents—are behind H.R. 219. Where our differences exist, they exist on the edges. So it is important to differentiate between those of us in the insurance industry who actually sell the homeowners' product and those who don't. Those who criticize the proposal that is before you generally aren't major providers of homeowners' insurance.

Two, it is suggested that this legislation is an industry bailout. Nothing could be further from the case. What we have today is a problem with no solution, and if the problem occurs, as we know inevitably it will, what will happen is we will go and the taxpayer will go to you with the hand out, and you will have to respond.

What H.R. 219 does is to provide the actuarially sound financing for such a system at no risk to the Federal Government.

We hear also that there is plenty of capital around to provide coverage for that 1-in-100-year-risk. That is simply not the case. We are the largest insurer in the State of New York. We have $475 million in reinsurance excess of our retention. We can't buy any more. Right now, the State of New York, while it is functioning, is going in a dysfunctional direction. Fannie Mae and Freddie Mac have said to Allstate that they won't accept—or probably won't accept—any more Allstate risk because of our 5 percent deductible on homeowners' coverage.

Our growth in the State of New York is far greater than any market would acknowledge as a part of the competitive marketplace. We know other insurers are not writing it. And as I said, the reinsurance capacity needs are not there. I think it is important also to realize this isn't a Florida, a California or Hawaii problem. Our members take us back to Iniki, take us back to Northridge, take us back to Andrew. But let's not forget the entire East Coast which is just as susceptible to these catastrophic effects as those three, as well as the heartland of our country, the New Madrid Fault, which Congresswoman Emerson talked about today.

The last iteration of the New Madrid Fault resulted in church bells ringing in Boston, scaffolding falling here in the Capitol, and a change in the direction of the Mississippi River. There are events that can take place for which the private sector simply can't respond, and the only way to correct that is a bill similar to the one you are proposing today in H.R. 219.

Thank you, Mr. Chairman.

[The prepared statement of Robert W. Pike can be found on page 303 in the appendix.]

Chairman LEACH. Well, thank you, Mr. Pike, for that very poignant analysis.

Mr. Musulin.

STATEMENT OF RADE T. MUSULIN, VICE PRESIDENT AND ACTUARY, FLORIDA FARM BUREAU INSURANCE COMPANY

Mr. MUSULIN. Thank you. My name is Rade Musulin, and I am Vice President and Actuary of the Florida Farm Bureau Insurance Company. I am a member of the Casualty Actuarial Society, and the American Academy of Actuaries. My company is——

Chairman LEACH. Excuse me, Mr. Musulin, if you could pull it a little closer.

Mr. MUSULIN. Excuse me.

My company is part of the Southern Farm Bureau Group, which insures property risks in southeastern States exposed to both hurricanes, as well as earthquakes. I am here before you today representing the Southern Farm Bureau Group and the National Association of Independent Insurers, a nonprofit trade association representing more than 560 insurance companies throughout the country.

Farm Bureau Insurance Companies provide many Americans with property insurance coverage through single State or regional companies. Companies like ours are crucial parts of the insurance marketplace, and I appear before you today to present the perspective of companies like ours operating on a regional basis.

My experiences in Florida have convinced me that the best approach to solving this problem is one that uses public resources to complement rather than replace private sector capacity. I have seen firsthand the effects on Florida's economy and State government operations for being unprepared for Hurricane Andrew, and we have paid a dear price for that.

I have three key messages for you today, first, that we support efforts to enact legislation to better prepare for extremely large and devastating natural disasters; second, that we are very pleased to see that the subcommittee, in reporting H.R. 219, included provisions for excess-of-loss catastrophic reinsurance contracts; and, third, that we strongly agree with the subcommittee that the State level is the most appropriate geographic focus for the sale of reinsurance contracts and disagree with those who have argued that such contracts should only be made available on a national basis.

I would like to briefly elaborate on these points. First the Federal Government can play a very constructive role in partnership with States and the insurance industry in ensuring not only that the claims get paid in the storm, but that the system can function efficiently the day after the storm to avoid disruptions to consumers of the type we saw in Florida. Though crafting legislation has proven to be very difficult over the years, it is critically important to millions of Americans who live in disaster-prone areas.

Having participated in the creation and implementation of the Florida Hurricane Catastrophe Fund, I can attest to the challenges and difficulties that may face other States if they elect to create State funds. While Florida Catastrophe Fund has been very successful, what has worked in States with the most severe problems may not be best for the rest of the country, and for this reason we

agree with the subcommittee that Federal excess-of-loss contracts should be a key component of natural disaster legislation. They would allow the Government to enhance the claims-paying capacity in many States without the need for additional State government programs, while not interfering with the State's ability to maintain existing programs or to create new ones.

We urge the Banking Committee to adopt the concept contained in H.R. 219 for a State focus for these excess-of-loss contracts so that single State or regional operations like mine can participate without having to bid on what are likely to be more expensive national contracts.

H.R. 219's current requirement for the States to create and administrate State auction programs we believe adds an unnecessary and expensive requirement that States act as intermediaries between the Treasury and private insurers. And for this reason, we urge that H.R. 219 be amended to allow insurers and reinsurers to purchase excess-of-loss contracts directly from the Treasury Department. We believe this change will bring broader insurance industry support for H.R. 219.

There has been a great deal of debate over the trigger for these contracts, and I will not attempt to state a number today in my testimony. However, we believe that the Treasury contracts should be triggered by substantial losses which would threaten the solvency of the insurance industry and its ability to continue to serve policyholders.

In closing, I note that consumers in many States are facing property insurance availability problems, and these problems will explode if there is a severe catastrophic event of the type that was described here a few moments ago. This issue is critically important, and even though it is difficult to craft a solution, it should be a high priority for this Congress and the Administration.

Thank you.

[The prepared statement of Rade T. Musulin can be found on page 309 in the appendix.]

Chairman LEACH. Thank you, Mr. Musulin.

Mr. Joslin.

STATEMENT OF ROGER JOSLIN, CHAIRMAN OF THE BOARD, STATE FARM FIRE AND CASUALTY COMPANY

Mr. JOSLIN. Thank you, Mr. Chairman.

As introduced, I am Chairman of the Board of State Farm Fire and Casualty Company, the largest writer of homeowners' insurance in these United States. State Farm strongly supports the principle of a Federal role in backing up in a financial way large, very large natural catastrophes. We very much appreciate and applaud the bipartisan consideration of and support for this concept. While H.R. 219 is not perfect, it is good. We certainly hope that the pursuit of perfection does not cause us to avoid accomplishing the good.

Federal financial backstops should follow several principles. First, the resources of the Federal Government should come into play only very rarely. Second, the price of Federal backstop mechanisms should properly reflect expected losses, not subsidies for catastrophe-prone areas while recognizing the superior capacity of

the Federal Government to absorb the timing risk of mega-catastrophes; a subject that Dr. Summers alluded to with great understanding. And, third, the backstop mechanism should have certainty and continuity, so as not to evaporate during or following a major event.

H.R. 219 represents a very sound approach. It meets the first two principles head on; it can be strengthened as to the third principle. Insured losses for major natural catastrophes in several regions of the country, such as California, the Southeast, including but not limited to Florida, and the midwestern earthquake zone could reach as high as $75 to $100 billion.

Events of this magnitude far exceed the claims-paying capacity of most private insurers serving these markets, and we would emphasize, all existing State funds. Other regions facing potentially devastating catastrophic losses include the upper Atlantic Coast, and the Gulf States. And there are smaller markets with very high potential losses in relation to the size of the markets, such as Hawaii and Alaska.

Although the U.S. has witnessed major events, such as the New Madrid Earthquake of the 1800's, the 1906 San Francisco Earthquake, the 1938 Long Island hurricane, Iniki and Andrew in 1992, and Northridge in 1994, the fact that these events come to mind and not others demonstrates how rare these very large occurrences are.

Yet after the events of 1992 and 1994, homeowners' insurance markets in Hawaii and major parts of Florida and California became dysfunctional. State-sponsored mechanisms to assume and pool the most severe of these risks were the responses necessary to reopen insurance and thus real estate markets. These necessary, but limited mechanisms would barely be able to respond to events the size of Andrew and Northridge, let alone the very possible much larger catastrophes. They would for many years have absolutely no ability to cope with a second event.

Although State funds cannot provide a total solution to the natural catastrophe problem, theoretically there is more than enough capacity, meaning capital, in private markets to insure or reinsure the worst of natural disasters.

This theory fails in practice. Primary insurers in the aggregate have substantial capital, but relatively little of it is devoted to homeowners' insurance in mega-catastrophe-prone areas. Many companies do not write homeowners' insurance at all. GEICO is a prominent example of that. Those that write may avoid catastrophe-prone areas due to limited capital, concern about earnings volatility, or fear of politically motivated rate suppression. Others, such as some who participate in the very competitive markets of Illinois and Iowa, simply don't view Florida and New York and California as part of their natural markets.

Few years of profitability without an event the magnitude of Northridge or Andrew does not diminish the need for Federal backstop for a 1-in-100-year event. Following Andrew some commentators in Florida observed that except for one event, the Florida insurance business has been profitable. So it has. That one event, however, consumed more capital than State Farm Fire and Casualty Company had accumulated in over the 60 years of its exist-

ence in the entire country. Private reinsurance is not the answer, because reinsurers have a relatively small capital base, and they must reasonably balance their portfolios.

Finally, the capital markets, pension funds and other institutional investors, have large financial resources but very little has reached the catastrophe insurance market and the price has been high; 8.2 times the estimated average annual loss costs in the one significant transaction to date.

After a major event, the price of such securities, if available at all, most likely would be higher. Too often financing of a natural catastrophic loss is described as accumulating over a period of years the amount of money necessary to pay the loss. Unfortunately, a 100-year or a 10,000-year event can occur in the first year. No private enterprise can earn a competitive rate of return in the business of insurance sitting on this quantity of stagnant capital.

Moreover, the United States tax policy further aggravates the problem. In most years, insurance of high magnitude, low incidence events generates tax liabilities on profits that do not exist. And having been in Washington on more than a few occasions on issues of tax legislation, no matter how much I might like some cure in this arena, that is a land mine on which many of us fear to step.

H.R. 219 is a major improvement of the status quo.

Chairman LEACH. Yield for a moment there. You have generally won, Mr. Joslin, the insurance industry does well.

Mr. JOSLIN. I am not sure about that. In 1997, the loss carryback provision was reduced from three years to two years which has a significant impact on what our capacity is to respond to large natural disasters, with due regard, sir.

The most important features of H.R. 219 are Federal reinsurance for State funds set up to insure or reinsure catastrophic risk, and a price based on estimated average annual losses plus a reasonable margin for the contingency of loss estimation error. I call that consumer friendly pricing.

We, of course, could support excess-of-loss contracts as an approach. H.R. 210 has that feature in it. That probably could be improved upon and perfected, but nevertheless is certainly something that we would not reject.

H.R. 219 could be strengthened if it better addressed the very small possibility of multiple mega events in the same year. The mere possibility of unfunded catastrophic losses sends tremors through the insurance and lending communities. The committee should consider transforming the bill's $25 billion limit per year into a per event limitation as opposed to per year.

The proration of claims for people who have bought insurance and thought they had insurance is just as devastating for insurers or State funds as it is for the policyholders of the California Earthquake Authority.

In conclusion, a 100-, 500-, 1,000-, 10,000-year event by definition occurs very rarely, yet such an event could occur tomorrow. Now is the time for Congress to act when the country is free from the trauma of a major catastrophic event.

Mr. Chairman, we commend your work and we are available to assist in any way we can.

[The prepared statement of Roger Joslin can be found on page 313 in the appendix.]

Chairman LEACH. Thank you, Mr. Joslin. I appreciate it.

Ms. Bouriaux, are we pronouncing that closely?

Ms. BOURIAUX. Very good, actually.

STATEMENT OF SYLVIE BOURIAUX, GROUP MANAGER, FINANCIAL PRODUCTS, CHICAGO BOARD OF TRADE

Ms. BOURIAUX. Mr. Chairman, Mr. Lazio, Members of the committee, as Group Manager of Financial Products for the Chicago Board of Trade, I direct the Exchanges' research and product development efforts in the insurance area.

The CBOT appreciates the opportunity to discuss the latest developments in catastrophe reinsurance alternative products, most specifically the PCS catastrophe insurance options currently traded at the CBOT.

In 1848, the CBOT was founded to provide rational, effective and ineffective mechanisms for buying and selling physical agricultural commodities. Today, we sponsor trading in over 60 different futures and options markets, including a centralized market for buying and selling catastrophe risk. These markets provide an efficient, reliable mechanism for transferring the risk and generating price information that is disseminated around the world to provide a benchmark for market decisions.

In the aftermath of Hurricane Andrew in 1992, the insurance industry began to devise sources of funding, recognizing that increased reinsurance capacity was needed. At the same time, capital markets, including the Chicago Board of Trade, recognized this need and introduced new products, such as the Board of Trade CAT options, swaps or bonds to expand reinsurance capacity and improve market efficiency.

In fact, in the spring of 1992, even prior to the occurrence of Hurricane Andrew, the CBOT had already begun to develop capital market solutions. The first CAT products began trading at the Exchange in December of 1992. The second version of this contract, based on aggregated insured catastrophe loss estimates compiled by the Property Claims Services, or PCS, began trading in September of' 95. Today, the CBOT's product mix includes options for nine different regions and States, National, East, Southeast, Northeast, Midwest, West, Florida, Texas and California, and we probably could add as many as we can.

PCS options can be used as synthetic reinsurance covers to protect and compensate insurance industry participants against catastrophes that would trigger up to $50 billion of insured losses in each of those nine regions and States.

In the past two years—I'm sorry, other exchange-based initiatives have followed in the CBOT footsteps. First, in 1996, the Catastrophe Risk Exchange, or CATEX, was created in New York. A year later, the Bermuda Commodity Exchange opened its doors to trade insurance options basically conceptually similar to the ones we trade at the Board of Trade.

Generally, exchange-traded CAT instruments differ from reinsurance in that they are more standardized and not negotiated as traditional reinsurance. The buyer and the seller of these contracts do

not negotiate the specific terms of their contracts, but only their price, or if you want a premium.

CBOT options are very similar to the aggregate excess-of-loss contracts described by Mr. Summers in his earlier testimony. They allow an insurance or a reinsurance company to buy a layer of protection between two attachment points or, as we like to call them in our financial jargon, strike prices. If aggregate losses fall within that layer, the insurance company will be compensated, minus, of course, a premium paid up front. Collecting this compensation is assured by the financial backing of the AAA-rated Board of Trade Clearing Corporation, which insures the total integrity of the market.

The tradability and price transparency of the CBOT contracts has attracted new sources of capital from beyond the traditional reinsurance market. Investment funds, commodity and pension funds, as well as other risk-takers use CAT contracts as another way to diversify the portfolio risk. Reinsurance capacity channeled through the CBOT, although small to date, about $80 million since September of 1995, is growing rapidly, as open interest in the PCS catastrophe insurance options, which is—if you want a measure of the capacity handled through our market, grew by 65 percent between 1996 and 1997. This number is even more remarkable as the traditional catastrophe reinsurance market has considerably softened over the last two years.

To date, we have seen transactions in all nine regions and States offered at the exchange. Unfortunately, regulatory and accounting barriers deprive many potential users of the benefits of the CAT contracts at the Board of Trade. Only California, Illinois and New York have expressly addressed an insurance company's authority to engage directly in exchange-traded derivative products, insurance derivative products. In each of these jurisdictions, such authority has been limited to hedging transactions.

In addition, the National Association of Insurance Commissioners, the NAIC does not treat CAT contracts like reinsurance for accounting purposes. For example, if insurance companies manage their risk exposure by purchasing traditional reinsurance, they are rewarded by being allowed to increase the level of coverage that they write. No such increase is granted to companies managing their risk exposure through CAT contracts at the Board of Trade, thereby penalizing companies for using CAT contracts and certainly discouraging the number of potential companies from utilizing these risk management tools. These are issues the CBOT and others involved in innovative insurance risk management will try to continue to resolve.

In addition, the Board of Trade is also cosponsoring an initiative currently dubbed the Chicago Board Insurance Exchange, or CBIE. The CBOT, using a consulting firm, is exploring the economic viability of the creation of this new insurance exchange in Illinois. Seeking insurance and capital market partners, the CBOT hopes to create and develop a risk distribution mechanism solely for novel forms of insurance, like, for example, company specific warrants or index-based warrants, which could be divided and retreated in a secondary market.

The goal of the Chicago Board Insurance Exchange is to efficiently allow risk-seekers to treat the risk posted as insurance, while allowing risk assumers to be members of both the reinsurance community as well as the investment community.

To date, as you may know, State insurance laws do not allow for private investors to directly handle the business of insurance, hampering access to this pool of available capital. If the CBIE evolves as planned, this initiative would provide an attractive alternative tax and regulatory environment to compete successfully with offshore locations, such as Bermuda, which are currently attracting such U.S. insurance business.

The CBOT and other exchange-based initiatives offer creative risk mitigation alternatives to insurers that can supplement traditional reinsurance coverage. Such contracts can also be extremely beneficial to the reinsurer, who can, at a low cost, transfer some of its risk to the financial markets, thereby freeing resources to write additional direct catastrophe coverage to primary insurance companies. Our experience continues to demonstrate that a market for innovative instruments to manage insurance risk does exist, and that investors have an appetite for that risk.

Thank you.

[The prepared statement of Sylvie Bouriaux can be found on page 318 in the appendix.]

Chairman LEACH. Well, thank you, Ms. Bouriaux, and it is important that we hear counter-perspectives presented and I think you presented a very thoughtful one.

Mr. Nutter. You two may be talking from the same handbook. I don't know. Please proceed.

STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT, REINSURANCE ASSOCIATION OF AMERICA

Mr. NUTTER. From related ones.

As a representative of the domestic reinsurance industry, we support the need for a high level Federal role in providing catastrophe reinsurance, excess of that available in the private market and through State catastrophe insurance funds.

This position is rooted in the following principles, that natural catastrophes are insurable risks and reinsurable risks in private markets, that the Government's role should be to address the potential of insurer insolvency in the event of a mega-catastrophe, that catastrophe insurance should be provided to the public in a diversified marketplace, which avoids the concentration of risk. The private sector's role should be maximized at both the State and the Federal level. The Government should encourage pre-disaster mitigation, and any Federal role should address both personal and commercial insurance.

Since the early 1990's, many private sector developments, positive developments in the private market, have added to the ability of insurers, reinsurers and the capital markets to provide capacity for insuring catastrophe risk. The insurance industry surplus has doubled since 1991, which includes the natural catastrophes of Hurricane Andrew and the Northridge quake, as mentioned in your opening statement, Mr. Leach.

Most, if not all, insurers better manage their catastrophe exposure. New capital markets from such notable investment, banking and securities organizations, such as the Chicago Board of Trade, Goldman Sachs, Morgan Guaranty Trust, J.P. Morgan Securities, Credit Suisse First Boston, and AON Re Services, offer catastrophe insurance products and the potential for extraordinary additional capacity. Reinsurance capacity is at an all time high and prices have dropped to near pre-Hurricane Andrew levels.

State studies show that in most markets insurers are providing coverages, new insurers are seeking new opportunities in many of these markets and consumers are being better served. The fundamental problem, in our view, remains the potential devastating effects of a mega-catastrophe that potentially compromises the integrity of insurance companies.

An excess-of-loss reinsurance approach such as that contained in H.R. 230 offers, in our view, the most constructive basis for providing Federal reinsurance to private markets and existing State funds.

H.R. 219, on the other hand, is premised primarily upon Federal Government reinsurance of other Government programs and as such is too narrow. It would provide an incentive for many States to adopt State Government programs, thereby concentrating catastrophe risk in taxpayer-financed vehicles, rather than encouraging private market solutions. Appropriate private-public partnerships need to be created to ensure that insurance is widely available to consumers to finance recovery from natural disasters.

Thank you very much.

[The prepared statement of Franklin W. Nutter can be found on page 329 in the appendix.]

Chairman LEACH. Thank you, Mr. Nutter.

Ms. O'Hanlon.

STATEMENT OF ISOLDE G. O'HANLON, MANAGING DIRECTOR, CHASE SECURITIES, INC.

Ms. O'HANLON. Thank you, Mr. Chairman.

My name is Isolde O'Hanlon. I am a Managing Director in Chase Securities, Inc., which is a unit of the Chase Manhattan Corporation. I am happy to be here this afternoon to talk to you about catastrophe finance.

Over the last several years, Chase has been actively involved in California, Hawaii and Florida, in terms of assisting the pools in those States with both financing in the private markets, and the bank market, and also providing advice to them.

Since 1994, Chase has raised in excess of $7 billion for the CEA, the FWA and the Hawaii Hurricane Relief Fund. These pioneering programs operating at the State level restore and ensure the continued availability of residential property insurance. These pools provide insurance both to regular homeowners, as well as in the case of the Florida Hurricane Catastrophe Fund, provide reinsurance to all firms operating in the State of Florida.

California, Florida and Hawaii, as you have already heard today from many of the participants have experienced severe catastrophic losses over the last several years, and the State markets in those three jurisdictions have responded.

In 1992, following Hurricane Iniki, the Hawaii Hurricane Relief Fund was formed. The California Earthquake Authority was formed following the Northridge Earthquake. However, the situation and the devastation in Florida that resulted from Hurricane Andrew was quite different even from what happened in both of those States, and the response there was equally large.

In the case of Florida, two new pools were formed after Hurricane Andrew, the Florida Hurricane Catastrophe Fund to provide, as I said before, reinsurance, but also because of the severe disruption in the primary homeowners' market, there was a reason to actually legislate a primary insurance company, and the Florida RPC JUA was formed, growing to be the third largest insurer in the State of Florida.

In addition to that, the territory of the Florida Wind Storm Underwriting Association was expanded from dramatically from the Florida keys to cover 29 of Florida's 35 coastal counties.

Given current demographic trends in the United States and particularly the recent increase in real estate development in coastal and other catastrophe-prone areas, the potential for loss in these areas has grown exponentially. In order to avoid excessive exposure to one particular catastrophic event, reinsurers, and even for that matter, primary insurers create geographic or zonal limits to the amount of coverage they provide. The limit is typically set to ensure a single catastrophic event will not deplete a specified portion of the reinsurer's capital. The increase of exposures in certain areas has created a larger disconnect between the needed level of coverage in certain areas and the availability to buy coverage at a desired price or premium level.

This is particularly apparent if we compare the situations as they exist today in Hawaii and Florida. For example, the Hawaii Hurricane Relief Fund today can purchase reinsurance coverage well in excess of its 1-in-100-year event of $650 million. Such is not the case as exists today in Florida. The Florida Wind Storm Underwriting Association, which has seen a marked decrease in supply in reinsurance over the last several years, is barely able to approach sufficient reinsurance to cover the 1-in-100-year event, which is at approximately $5 billion today. Since the introduction of financing for catastrophe pools, several billion dollars has been raised.

Most recently, risk transfer products have also been introduced to the markets in the form of what you may have heard referred to as catastrophe bonds or CAT bonds. These products actually provide risk transfer and there is no repayment associated with them, so they are very different than the syndicated lines of credit, than the pre-event notes or, for that matter, the reinsurance that has been provided in the past. The investors who are investing in these securities will bear the risk of catastrophic events.

It is important to note that although the risk transfer products which have great potential in the market, today the market is in the early stages of development and there are probably 60 to 80 investors today who invest in these types of securities.

As the capital market product continues to grow and evolve, we will see increased benefit in the form of reduced price for both State and individual corporations.

The obvious question becomes, that has been talked about today, what is the breaking point that defines an extremely low frequency and high severity event, and very often today we have heard other speakers talk about the 1-in-100-year event. I think an important thing for the committee to keep in mind is what does the 1-in-100-year event mean in different geographic jurisdictions. And what I mean by that is the 1-in-100-year event is something very different in Florida than it is for, say, the State of Wyoming, and very different in terms of the economic magnitude.

Much has been made today about talking about the availability and the affordability of homeowners' insurance immediately following an event and whether or not the introduction of either State or Federal programs interferes with the private market's ability to provide insurance.

I wanted to just take a couple moments and comment on the importance of looking at actuarial modeling, including looking at rate setting in both individual States as well as with the Federal program, and just mention that in the case of the programs that we have heard talked about here today in California, with the CEA and Florida with the Hurricane Catastrophe Fund as well as the Florida Wind Storm Underwriting Association and with the Hawaii Hurricane Relief Fund, all of those markets experienced extreme disruption after the various events and catastrophe modeling was used for all of those entities on a post-event basis to determine the appropriate rate structure. It wasn't always popular but it was the right thing to do, rather than charging a rate, which is inefficient or below the appropriate market rate and having the taxpayers foot the bill at a later date and time.

There has been much discussion today also about loss mitigation. I just wanted to point out in the case of all the funds we talked about today, they are all required by State statute to set aside a certain portion of their revenues to provide for loss mitigation. Most of these funds, since their inception, I mean, the Florida Hurricane Catastrophe Fund, the CEA and the HHRF have been loss free. In the case of Hawaii, that has led to an accumulated surplus in excess of $100 million. And there has been some discussion in the Hawaii State legislature about what to do with the $100 million, and whether or not that should go into the general State revenues. It is pretty clear in the legislation before the HHRF that is not an appropriate use of the funds and what they are looking at now is to provide credits to policyholders to enable them to pursue loss mitigation.

Just one last comment, which is to say that the $7 billion in financing that has been completed in the form of bank financing and pre-event bond financing, which has been done for the pools in Florida is along the lines of traditional corporate financing and those entities are taking a security interest in future policyholder assessments, which basically spread the risk of loss over time.

Thank you.

[The prepared statement of Isolde G. O'Hanlon can be found on page 345 in the appendix.]

Mr. LAZIO. [presiding]. Thank you very much.

Mr. Weber.

STATEMENT OF JACK F. WEBER, PRESIDENT, HOME INSURANCE FEDERATION OF AMERICA

Mr. WEBER. Thank you, Mr. Chairman.

I want to start by saying that on behalf of the Home Insurance Federation of America, which represents the large homeowners' insurance companies in this country, we would like to express our deep gratitude to both you, Mr. Lazio, and Mr. McCollum for your leadership on this issue, for sticking with it at a time when a lot of people said there wasn't a problem. I think that today's hearings indicate that you were right, that there is a problem, and therefore we are very encouraged by today's hearing.

I think that one of the reasons that this particular panel was convened was to try to give you some perspective on exactly what the arguments are in terms of the capacity of the private financial markets to deal with this problem, and I think that our role today is to try to give you some sense of where those limits are.

We believe at HIFA that there is a role for the capital markets. It is an important role, but we also think it is not in all cases the best solution if our goal is to have affordable insurance for all Americans. If our goal is to truly be prepared for the mega events, we think that a Federal role is in fact necessary.

The laws of economics indicate where the limits of private sector capacity are. This morning we will show you, through some very real examples, where we think the limits of the private market are.

Large natural disasters are a matter that cannot be handled efficiently without the stabilizing influences of a Federal Government. The U.S. Army is not listed on the U.S. Stock Exchange for a very good reason. We did not go to the moon using bonds. There are certain issues in which the Federal Government must play a role and we believe that catastrophic disasters are one of them.

In terms of the financial markets, there is a difference between identifying an appropriate niche for these sources of capital and proclaiming them a savior to the problems of growing insurance availability, and I think if there is one thing that is most significant about anything any of the panelists here today have said, it came from Mr. Joslin, who is not a member of HIFA, but I want to emphasize what he said about Hurricane Andrew, in that Hurricane Andrew cost his company more than all of the money that the largest homeowners' insurance company in the country had collected for 60 years nationwide, and that is a telling statement, I think, about the nature and the size of the events that we are talking about. And by the way, that was a 30-year event in Florida, not 100-year event.

I would also like to point out that two of HIFA's members, Allstate and Safeco, are the largest buyers of private reinsurance in the United States when it comes to homeowners' insurance companies, so that HIFA members know something about the capital markets, what they cost, and why we have the problems that we do today.

It is no accident, in our opinion, with all due respect to the previous panelists, that the Chicago Board of Trade, who has been in this business of trying to market catastrophe bonds for now three or four years, has never sold more than $30- to $40-million worth of contracts in any given year. Thirty or $40 million, I would re-

spectfully submit, is one one-thousandth of what we expect a major hurricane strike in Miami to cause in terms of losses.

It is no accident that the Catastrophe Risk Exchange, an enterprise started two years ago by a former deputy insurance commissioner in New York, has 300 sellers, but only two buyers to date. There is a rational explanation for why the number of catastrophe bonds sold to insurance companies in the United States can still be counted on one hand, even though the marketplace is clamoring for solutions. And there is a reason that to date, the capital markets have only provided a billion dollars worth of capacity. A billion dollars does not get us very far at all in terms of the kinds of exposures that we are talking about.

The reason that these solutions have not caught on more quickly is that they make only marginal economic sense. If they made more sense, more people would be buying them, just as people are buying nearly everything else that Wall Street is offering these days. Few are buying because the transactions are not cost-effective, and they will not be cost-effective in the future because high cost infrequent natural disasters cannot be efficiently priced in the private market. This is not an indictment of capitalism. This is simply the truth, and it is not to say that at lower levels, reinsurance is not a cost-effective transaction. After all, reinsurance has been around for centuries. You can reinsure an office complex, you can reinsure an insurance company with a few hundred-million dollars worth of exposure, but it is entirely a different matter when we are talking about reinsuring an event that could destroy St. Louis or New Orleans.

The pricing dynamics of reinsurance and similar capital instruments become problematic when dealing with catastrophies that occur less than once every hundred years. Investors are only willing to invest if the return on their money is comparable to what they could earn with alternative investments.

The only problem is that homeowners' insurance is not sold to the public according to the same rules. Homeowners' insurance is regulated, and that is a point that I don't think has been mentioned yet today. It is priced on the basis of risk, not the desired rate of return in capital markets. What chance is there that a homeowner will have a claim and how large, on average, is that claim likely to be? These are the relevant questions in the homeowners' insurance market.

For example, if there is a 1 percent risk of a certain size loss, the homeowner is charged approximately 1 percent of that potential loss each year. The same principles apply to every kind of insurance, it is what insurance regulators allow, consumers expect, and elected officials, whether they be Members of Congress, a State legislator or a governor, demand.

Financial markets and insurance markets do not operate on the same playing field when it comes to addressing large catastrophes that occur infrequently. These differences are particularly pronounced when we move into the higher levels. If a capital market is going to reinsure a $25 billion catastrophe, investors quite rightly expect a rate of return of at least as good as what they could earn elsewhere, but such a return is many times what insurance

companies are permitted to charge homeowners and far more than the underlying risk that a claim will occur.

To illustrate this, I brought along a couple of charts because I think it is very important in this discussion about what the capital markets are capable of to emphasize that the limiting factor is not the lack of money, it is the price. And if I could get a little help on those boards, I would actually like to move from that board to the next one, please, actually it is the third one.

What this is is an illustration, real life illustration I might add, of the California Earthquake Authority, which is an excellent proxy for what an insurance company would face trying to ensure earthquake exposures for an entire area. And what you see from that chart is that the claims paying capacity of the California Earthquake Authority is $7.5 billion, and of that, $2.5 billion is reinsured.

You will note that Mr. David Knowles, who was an earlier witness, testified to the fact the CEA is the largest buyer of reinsurance in the world. They buy more by a factor of three or four times what anybody else in the world buys. The premiums that are collected from consumers in California for earthquake exposures is $700 million. That represents a fourfold increase in the premiums that were charged just three years ago.

In order to buy $2.5 billion worth of reinsurance, the CEA pays $320 million a year. That is virtually 50 cents out of every dollar that is collected from California consumers, for simply $2.5 billion worth of coverage. That means that two-thirds of all losses to the CEA are not reinsured, and all events above $7.5 billion are not covered.

If we could have the next chart, please.

Now if you break down the reinsurance that the CEA is buying, there are two layers that the CEA buys. One is sold by Warren Buffett and his reinsurance company. It is a billion dollars worth of coverage. For that billion dollars of reinsurance, the CEA pays $115 million per year. That represents a 10.8 percent return on Mr. Buffett's money.

However, the risk that Mr. Buffett will have to pay off on that billion dollars is only 1 percent, which means that even though the underlying risk is only 1 percent, the capital market is demanding 10 times that amount to provide that billion dollars of reinsurance.

I think that what this indicates is that there is a limit to what any entity can afford to pay for reinsurance. If you are already paying 50 cents out of every dollar to buy $2.5 billion, how could it possibly be argued that the appropriate level for Federal reinsurance should be $10-, $15-, $20-, $30-, $40-billion dollars. If $2.5 billion of reinsurance costs 50 cents out of every dollar collected from consumers, then that must show that reinsurance at high levels is simply not affordable.

But I don't think it is fair to argue that Mr. Buffett is not acting reasonably from his perspective. He has alternatives for that billion dollars that could easily return 10 or 11 percent, and so, therefore, I think that Mr. Buffett is acting rationally from his perspective, but I also think that the CEA is quite rational in saying that if they are incurring a 1 percent risk, but having to pay 10 times that

amount for the reinsurance coverage, that this is not an affordable transaction beyond certain limits.

In closing, I would just like to emphasize that the key issues that the Committee has to realize and look at are, if in fact it is going to provide reinsurance, that reinsurance must be at a workable level relative to what is going on in the marketplace today. If you provide reinsurance at too high a level and at too high a price, you will not affect the availability of homeowners' insurance, you will not encourage more people to buy homeowners' insurance coverage, and the problems that we have today will continue.

Thank you.

[The prepared statement of Jack F. Weber can be found on page 362 in the appendix.]

Mr. LAZIO. Thank you very much.

Mr. JOSLIN. Mr. Chairman, if it please you, without taking away from the general tenor of Mr. Weber's message, I believe that his reference to State Farm Fire and Casualty was money collected, which would be revenues. My statement was accumulated capital, which is underwriting profits, plus investment income, plus contributed capital, a significant difference between the two.

Mr. WEBER. I stand corrected.

Mr. LAZIO. Mr. McCollum.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman.

With this large a panel and so few of us here, I hope we can have more than one round.

I will begin by asking Mr. Joslin, since you were the last one speaking here, a question. In his testimony earlier today, Secretary Summers indicated that the Treasury would like to see us modify H.R. 219 to provide for the sale of excess of loss contracts to all entities on an unrestricted basis. I presume that is similar to the request, in a way, that Mr. Musulin was just making, to not have this necessarily go through the States for auction purposes. If that were done, does State Farm have a problem with that? I realize the devil is in the details, but in the broad general principle.

Mr. JOSLIN. First of all, I believe a sale through the Treasury, as Mr. Musulin suggested, would be less cumbersome than on a State-by-State basis. Whether or not the contracts are on a State-by-State basis, involving the State governments could be a very cumbersome process.

In answer to this question of allowing broader than simply insurance companies or broader than simply State plans to be a participant in this process, it has been our view all along that if one is seeking an efficient auction market and if one is wanting an efficient use of the capital and reinsurance markets, the product should be available to all potential purchasers, which is the best way to assure there is not underpricing. Nobody is going to buy an overpriced excess-of-loss contract. There will be people who will come forward if it is obviously underpriced.

Mr. MCCOLLUM. Mr. Pike, do you generally agree with what Mr. Joslin just said with regard to the unrestricted opportunities for excess-of-loss contract purchases, if we go that route?

Mr. PIKE. I don't really have a problem with a primary carrier being able to access the Federal excess-of-loss contract, rather than using the State as the vehicle for that.

I do have a philosophical problem with the auction generally, if in fact it produces the result of having the biggest and the most wealthy participants dominating the auction. That would trouble me, even though we happen to be a very large company.

I think the way H.R. 219 is designed is very appropriate. It sets a premium at twice that which is actuarily required, provides everybody the opportunity to access Federal reinsurance at a known, fixed, firm price, represents a premium on that which is required actuarially, and yet provides additional revenues to the Federal Government ultimately to pay for these losses when they occur. I have trouble with the auction concept because it may kick up the price of the contract far beyond the actuarially-driven rate. These extra costs will ultimately be passed on the the consumer.

The beautiful part about two times the actuarially-driven rate is that it caps the rate to the consumer, and in the final analysis, we know that with the capital markets, their money comes and goes very quickly. As a homeowners' insurer, we can't. If we are in the State of Florida, we have to stay with our policyholders and we can't turn around and say, for example, after Hurricane Andrew, that the price of reinsurance went up 500 percent and we are going to pass that on to you because that is where the auction set it. So what we are really trying to do here is temper those increases to the consumer, and I think the two times actuarial driven premium accomplishes that better than the auction.

Mr. McCollum. Mr. Nutter, what do you think about the auction versus the two time actuarial rate that Mr. Pike is talking about.

Mr. Nutter. About the State auction or the notion of a Federal auction?

Mr. McCollum. Either one. I think what Mr. Pike was just saying is he didn't think it mattered. He would be happy to have either Federal or State but he didn't like the idea of the auction, he wanted it to be set more precisely.

Mr. Nutter. Well, we certainly endorse the idea of the auction. It does facilitate the development of private market facilities. Mr. Weber talked about limitations of capital market products. It seems to me that a national auction would indeed facilitate the creation of private capital market capacity. We agree with Mr. Joslin that a State-by-State auction process seems cumbersome and probably divides up the capacity and it would be inefficient. We are sympathetic, particularly to Mr. Musulin's point that the small regional companies probably are the biggest part of the solution to this problem and therefore, having them have access to excess-of-loss capacity is very important.

Mr. McCollum. All right. Thank you.

I think my five minutes are up, and if we are going by that rule here, I will yield back, Mr. Chairman, with the understanding, I presume, we will have another round. Thank you.

Mr. Lazio. Mr. Sherman.

Mr. Sherman. Thank you, Mr. Chairman. I want to commend Chairman Leach for holding these hearings, but especially commend you two gentlemen for being so involved in this issue. We have a lot to gain by dealing with this problem, and I am sure there are many times when you thought that this Congress was not going to be moving a bill and now at least I am far more optimistic.

I want to especially commend Mr. Lazio for putting together the bill that we are having hearings on today, and I hope you add my name as a cosponsor of that bill.

I think that, certainly, the people in my community are going to benefit because half of them are paying too much for their homeowners' disaster insurance and the other half are going without.

One thing that we haven't talked about much is the economic effect of the possible insurance crisis. We had an insurance crisis right after the Northridge Earthquake which caused the CEA to be created in California, but there is a tremendous national interest in making sure that people can insure their homes, sell their homes and finance their homes.

And then finally, as was brought up with Secretary Summers, the Government has a strong interest in making sure people can get and do get disaster insurance, both to reduce FEMA's cost, but also to reduce the cost to the Treasury of people deducting their uninsured disaster losses. We prefer they have insured disaster losses if there have to be disaster losses at all.

I want to see, Mr. Weber, if I can understand your chart, as far as Warren Buffett getting a premium of 10.8 percent. I have heard the 10.8 percent referred to sometimes as a rate of return and sometimes as a premium. It is my understanding that it is a premium and that Mr. Buffett's $1.075 billion in capital is available for him to invest in other assets, as long as those assets are pledged. So he makes a rate of return by investing his billion dollars, and gets a premium by putting his billion dollars at risk, is that correct.

Mr. WEBER. Well, it is safe to say that Mr. Buffett is actually not depositing a billion dollars in the coffers of the CEA, he is making a promise to pay off, if in fact an earthquake occurs, which means that while he has an obligation to make good on those payments, the money is not actually held by California.

You are also right that when we talk about a 10.8 percent, that is a rate of return on that billion dollars. So it is 10.8 percent of the billion dollars is his annual revenue, what the California Earthquake Authority pays him for that reinsurance. That is different than the risk that Mr. Buffett will actually have to pay off, that billion dollars, and that risk is 1 percent.

Mr. SHERMAN. The way I use the terms, I would just use the term premium and not the term rate of return, since rate of return usually applies when your capital is committed to a particular project and cannot be used for something else.

I know a number of speakers have said that people would not buy overpriced reinsurance. I think we have got a number of panelists here eager to buy reinsurance at only double the actuarially valid value, and simply object to a system where they have to pay 10 times the actuarial valid value.

The other question that has arisen is whether it is desirable to provide reinsurance directly to insurance companies in the casualty business operating in those States that do not have a fund like CEA. And one concern I have, or at least question, is that in dealing with CEA, the Federal Government is dealing with a very large pool that can pay the first $5 billion per incident or at least per year or per decade on its own, without tapping Federal reinsur-

ance. Would the Federal Government have to bear earlier dollar risk in order to provide reinsurance to the companies represented here?

Mr. PIKE. No, it wouldn't. There wouldn't be any additional exposure to the Treasury in the event that would occur.

Mr. SHERMAN. So if there were two equally sized States having equal earthquakes with equal amounts of coverage, one had a CEA and one had private companies buying their reinsurance directly from the Federal Government, the Federal Government's premiums would be the same and——

Mr. PIKE. No, I don't think so. It would be risk-based and there would have to be a determination.

Mr. SHERMAN. Assuming they have the same risk, have the same earthquake and the same homeowners'.

Mr. PIKE. Assuming the trigger was the same and the exposures were the same, and all other things being equal, there would be a similar premium charged by the Federal Government for those contracts, again, assuming the trigger point was also the same.

Mr. JOSLIN. Could I also respond to that?

Mr. SHERMAN. Yes, go ahead.

Mr. JOSLIN. We are talking about an auction of excess-of-loss contracts as a concept, whereby the loss is based on an industry aggregate loss, as opposed to selling the contracts themselves driectly to individual insurance companies, I don't believe that there is anyone at this table that is supportive of the Federal Government selling individual reinsurance to individual companies. We should make that distinction, because individual company reinsurance sales would require the Federal Government to be negotiating with each and every insurance company as to what their spread of risk is, their exposure, and that would, I believe, bring down the furies of hell upon those who don't want the Federal Government to be too deeply involved in the insurance business.

Mr. SHERMAN. So the theory in those States that didn't have a State agency would be that the Federal Government would deal with individual insurance companies but would have a particular contract with every company operating in that State that would not be company specific?

Mr. JOSLIN. It would not be company specific, it would be available to all companies doing business or providing reinsurance within that area.

Mr. Nutter, I am sure, feels strongly on the subject.

Mr. NUTTER. Just to try and clarify that. I think the excess-of-loss auction process would allow any individual company, if it felt it needed that coverage, however it was defined, to bid on, and therefore have it made available. If it choses not to, then it would not. But as Mr. Joslin says, I don't think anyone supports the notion that the Federal Government would directly reinsure individual companies. That is not what the legislation provides nor has anyone promoted.

Mr. PIKE. May I?

Mr. SHERMAN. Do we have time for one more panelist to respond?

Mr. PIKE. Just a point of clarification. The way the bill was currently drafted, in fact it is likely the excess-of-loss contract trigger would be significantly higher than would be possible under the re-

insurance plan portion of the program, making Federal involvement less likely, I believe.

Mr. SHERMAN. Thank you.

Mr. LAZIO. Thank you. Let me, if I can, just ask a few questions. I think at the heart of this, we are really talking about pricing, which is inherent in capacity, and an understanding that a very large catastrophic loss is unfortunately inevitable. Even worse, it may well be more than one incident, which is really the worst-case scenario, where an area is hit with two events in a major population center in the same year, and possibly even in the same State.

Is it true Mr. Nutter, that you believe the trigger from which the backstop should begin should be set at $37 billion?

Mr. NUTTER. I appreciate the fact you asked me that because I do want to clarify that. Staff brought that to my attention as maybe a misunderstanding.

I cited in the written testimony an example of how one would calculate a trigger using what I thought were conservative assumptions. But the point was that the insurance companies' retained earnings, called surplus, are really the cushion against shock losses. Therefore the surplus of the industry is an appropriate mechanism by which to calculate what a trigger would be.

I used, arbitrarily, 5 percent at the primary level, an additional 5 percent as an example of what you would lay off to reinsurers or large companies retaining, and then factored in 2 percent, which is entirely speculative on my part, to allow for the development of the capital markets products. So the point was not that $37 billion is the right number. I realize $25 billion has been floating around here for a couple of years. That may not be the right number either.

The point of my example was if you used industry surplus, it would adjust based upon the experience of the industry. If we had the mega loss and the industry surplus was depleted, the trigger would come down. Maybe it is lower than $25 billion. But if the industry surplus continued to grow, it would be higher than whatever numbers were used. That was the point of the example, not that 37 is the right number.

Mr. LAZIO. Let me ask Mr. Pike or Mr. Joslin if they can respond to that, and one of the implications, as we move up the ladder, in terms of the trigger, if it is at a $25- or $30- or $37-billion dollars for a company, what are the incentives for a company to write in an area that is disaster-prone?

Mr. PIKE. Currently the insurance industry has about $310 billion worth of surplus. Some assume that this surplus is available to back up homeowners' insurance, and of course it doesn't. Only about 10 percent of the industry's surplus does, or about $30 billion. Of that $30 billion, the surplus is spread around the entire country. It is not all backing up just California or just New York. So there is really just a very small part of the overall industry surplus that backs up the homeowners' line product.

The key, of course, is at what point do you have to protect, if you will, the solvency of those insurance companies, their ability to deliver an affordable product, their ability to deliver any kind of prod-

uct at all for that matter. The trigger becomes a very important issue.

We believe that given the level of surplus that is truly available on any given region, that that is probably what we generally use as the 1-in-100-year event, and that is a standard that has to be set by State. It can't be set nationally, we don't believe, because there will be different triggers in different States.

So from our standpoint, we think the 1-in-100-year event is a good test to determine what that trigger ought to be. It certainly isn't a $35 billion trigger on a national industry surplus basis. It is probably far less and we think that trigger is movable, depending upon what State is buying reinsurance and under what circumstances.

You could have a California CAT fund or a Florida CEA that has a $10 billion retention that, at that point and above, there is no really available and affordable reinsurance available. That is where the trigger ought to kick in, but $35 billion we think is far too high.

Mr. LAZIO. Anybody who would like to answer the question as to why is welcome. It appears there has been some maturation of the capital markets, but not nearly enough to make a dent in the demand for reinsurance—for risk being spread out over a wider population or a number of people.

Mr. MUSULIN. I think one thing to remember here is the insurance system, the way it had been structured, up until about the mid-1980's, underwent very serious shocks with Northridge, Hugo and Andrew, and in solving some of that problem through the capital markets, it involves the development of considerable new mechanisms, new regulatory procedures in order to allow insurers to make use of those mechanisms under the State laws they were regulated under, and that is a somewhat complicated process. And I think that it might be unreasonable to expect that process to have been completely brought to fruition in less than ten years, and so I think some of this is an issue that the capital markets are going to require some time to adapt to this situation, and that may help to close some of the gap that Mr. Weber pointed out with regard to the price differentials, and so forth.

Mr. LAZIO. Maybe I can ask Mr. Freedman. How would you characterize over the short and intermediate run, and I might set an arbitrary timeframe of between two and ten years, the possibility that the capital markets could assume all of the demand that is out there for reinsurance?

Mr. FREEDMAN. Speaking as only one company, I would say slight because of the progress we have seen over the past couple of years. I think Mr. Weber's chart shows it vividly. If the capital markets, at least Warren Buffett's company is getting higher than a 10.8 percent return, because he is going to have that billion dollars invested elsewhere. But he compares that, or the capital markets will compare, that against what other rates of return they can get, such as they are getting today in the equity markets. So there has to be a comparison between what you can get in an alternate investment vehicle and what the purchaser is willing to purchase. Of course, if we went out to the capital markets, you can only pass along so much of the expense of the capital markets coverage or so much the expense of reinsurance coverage, because the rates to

some extent are suppressed in many of the States. That just doesn't become a good match between what the customer and seller want to pay.

Mr. NUTTER. Mr. Lazio, do you mind if I supplement that answer?

Mr. LAZIO. No, I don't.

Mr. NUTTER. Two answers. One is that most analysts would say that the fairly soft pricing in the property catastrophe reinsurance market has made it more attractive for insurers to buy the reinsurance than it is to go to the more expensive capital market products and that if that changes, it is likely to enhance the development of the capital markets.

The second thing is that there clearly was, it seems to me, a novelty premium associated with the capital market vehicles in this first go-round. I believe analysis would show that the prices of the capital market products are coming more in line with corporate bonds, as opposed to equities, and therefore you are going to see them more attractive to a broader segment of the investor market.

Ms. Bouriaux may have a comment on that and she would be more knowledgeable than I would.

Mr. LAZIO. The only significant transaction I am aware of is the USAA transaction, and that was, as I understand it, very costly in terms of a premium, a very costly transaction. The point that we keep coming back to is the fact that insurance regulators regulate the cost of homeowners' policies, and those costs, the anticipated or the requested rate of return in the capital markets, can't necessarily be passed through to consumers. Is that true?

Ms. BOURIAUX. Mr. Lazio, the pricing of the CAT bonds has really narrowed since the USAA offering. I think the USAA offering was 500 business points above LIBOR. The latest transactions we have seen is a lot lower than that. And also there has been some secondary market trading that really has narrowed the pricing of those bonds as well.

And what Mr. Nutter just mentioned, which is a novelty of those CAT bonds, is very important and USAA, for example, was the first company to recognize that they were willing to pay such a high premium because they have a long-term view of what could happen in the future, and I think we tend to forget right now that we all have a little bit of a short-term view, but initiatives like CAT bonds or the Board of Trade products, we are there when the market was tightened. And I just want to make clear, for example, at the Board of Trade, if I could relate one experience that we have, the largest volume of transactions we did was about two hours before Hurricane Fran hit the shores and we traded in two hours 3,300 options for an equivalent capacity of about $15- to $16-million. Granted, it is pretty small. We are talking about a market that at the time was about 12 months in its infancy, but I think that shows you and the companies that you will see in the future those kinds of private market responses.

Mr. LAZIO. My last point would be there is obviously growth in the markets, which I think gives us some cause for optimism, but we have a short-term problem as well and we can only hope that we have enough time to watch the maturity of the capital markets to meet the demand that is out there.

I am going to turn back to Mr. McCollum to ask a couple more questions.

Mr. McCOLLUM. Thank you, Mr. Chairman.

Mrs. Kelly asked me to ask a couple questions for her. She had to run out. One is in the capital markets area and it may have been covered by that answer, but I am not 100 percent sure.

She wanted, Ms. O'Hanlon, for you to answer the question. It had to do with whether Chase had done any private market catastrophic deals. I don't know what she was getting at exactly, but that is the way the question was worded.

Ms. O'HANLON. I think probably she was talking about catastrophe bond deals, though it is not totally clear. And just to follow-up, the USAA deal was priced at about 550 basis points over LIBOR. The most recent deal which was done was for Trinity Re, which was primarily Florida risk, and that was priced at about 300 basis points. That is the deal that Chase most recently completed.

The USAA deal, in my understanding, is about to come to market in a couple months and will be priced substantially below the 550. We are seeing risk premiums that are more in line with what I talked about, about the 300 or perhaps less than that, perhaps down to 250 basis points, and I think there is a lot to be said for what Mr. Nutter said about the first time the USAA deal was done in terms of the novelty premium associated with that.

Mr. McCOLLUM. One of the other questions was to Mr. Weber. She wanted you to identify your members and I assume you can submit that for the record for us. I am not going to sit here and ask you to regurgitate every one of the big members that is a member for you.

Mr. WEBER. It would be my pleasure. We represent Allstate Insurance, which is the second largest company in the homeowners' insurance market, Farmers Insurance, which is the third largest, Safeco, Metropolitan Property and Casualty, and the Independent Insurance Agents of America.

Mr. McCOLLUM. One of the follow-up questions she had, does HIFA believe there is a need for other State funds besides the three that are there now? I guess it goes to the ultimate question of which direction we are headed, is there a desire to move, to have a State fund, more State funds created; does HIFA believe that is the case or not?

I think that is what she wanted to know.

Mr. WEBER. Well, first of all, I think that none of us want to see a proliferation of State programs. I think it's important to point out that States that have acted did so because had they not acted there would be no market for homeowners' insurance coverage. We don't think that H.R. 219 would encourage a proliferation of State programs. That is not our goal.

But I think that we are aware that the three places where major catastrophes have struck in the 1990's are the three places where those markets are not working. If we have our next major catastrophe strike in Louisiana or North Carolina, then we can probably expect similar problems in those States.

Mr. McCOLLUM. While we've got the microphone down at the end, Mr. Nutter, I would like you to clarify one thing. It's my question, not Ms. Kelly's here. But would, in your expectation, if there

isn't an excess-of-loss auction market feature put into place in one form or another here, would the reinsurance companies participate in such an auction market and buy contracts?

Mr. NUTTER. I think they would be most enthusiastic participants. In the process they would see it as additional capacity for themselves. They would see it as additional capacity for their client companies, which tend to be the Farm Bureaus, the small regional and local companies that they traditionally serve as their bread and butter clients.

Mr. MCCOLLUM. And they're much more likely to do that if there is an auction, is that correct? More likely to participate in an auction than in the model that does not have an auction?

Mr. NUTTER. That is correct.

Mr. MCCOLLUM. Mr. Campion, you have modeled an approach for us for H.R. 219. Have you modeled an excessive loss approach?

Mr. CAMPION. With regard to what we modeled, we assumed that the auction would follow in effect the same format in terms of the amount of money collected as the individual States would pay in if it was a State fund. For example, the fact that there would be a minimum price at a reserve price of two times the actuarial premium, we assumed that was what was collected in our analysis, because we had no way of knowing how the auction would work, or how much excess premium could be collected. That was the assumption we used.

Mr. MCCOLLUM. So, you have not another kind of assumption that maybe would be different from what Mr. Pike—I think the two times was his basic assumption?

Mr. CAMPION. That is correct.

Mr. MCCOLLUM. But you might do one down the road; if we gave you some other factors to go with, you could use your system to do that?

Mr. CAMPION. Yes, certainly we could do that, the assumptions would have to be what were the premiums collected in those auctions.

Mr. MCCOLLUM. Ms. Kelly asked me to ask you if your company brokered the CEA reinsurance?

Mr. CAMPION. Yes, it did.

Mr. MCCOLLUM. Some thought, she says, that that was a ripoff, and she asked if you agreed if it was?

Mr. CAMPION. No, I don't believe it was a ripoff. And I think one of the things for those people to keep in mind, and I think Deputy Commissioner Knowles put it very well, which is, the price for those purchasing coverage appears very high, and for those selling coverage appears low. And I think for those people that make comments like that we can always find an opportunity for them to put their capital at-risk through reinsurance mechanisms, if they think it's such a great deal.

Mr. MCCOLLUM. Just for the record, you did get a commission; it was brokered?

Mr. CAMPION. Yes, that is correct.

Mr. MCCOLLUM. And this is my last set here, if I can to follow-up Ms. Kelly's line of questioning, Mr. Chairman. With regard to State Farm and Allstate, she notes that there are surpluses that each of you have, which I think we all know, and she notes that

State Farm has a $37.6 billion and Allstate has a $17 billion surplus. I don't know the accuracy of those figures, but that is what she has down here. And she asks if the surpluses are being carried for catastrophic risk, if that is the reason for the surplus, and that is essentially what the question is I believe.

Would either of you gentlemen care to respond to that?

Mr. JOSLIN. Both companies are very large writers of automobile insurance, and I think both of us have said that the insurance business segregates, tends to place its capital behind various business opportunities, and certainly all of that surplus is not designed to support the homeowners' losses in a given geographic area. It is a much, much broader business obligation.

Mr. MCCOLLUM. Would you agree, Mr. Pike?

Mr. PIKE. Except I wish we had $16.5 billion. We have $12.5 billion in statutory surplus numbering.

Mr. MCCOLLUM. OK, that is fair enough. In conclusion, and I come back to myself now. I have asked mixed questions here, but a few that she asked me to and I'm sure I didn't cover all her questions. If her staff is here, I apologize, I don't have time to do that, but I did try.

I want to thank each of you. I know the companies here and Mr. Nutter, in particular, who represented, and a number of companies who aren't represented here today have just been doing exceedingly overboard efforts with Mr. Lazio and myself to come up with various ways we can make all of this work. And you have all been very capable and willing to come forward and tell us that you will participate in a variety of different versions of this and to help us craft something that we ultimately can use.

So I want to again thank you publicly for doing that. It is obvious that each company and each marketplace is a little different. But working together, we are going to come up with one yet. Thank you very, very much for doing this, and thank you, Mr. Chairman.

Mr. LAZIO. And thank the panel as well.

We have two votes stacked, and the first 15, the second 5, I think the earliest we will be able to come back is about 4:00 o'clock. So the hearing is in recess to hear the last panel until 4:00 o'clock.

[Recess.]

Chairman LEACH. The hearing will reconvene our final panel to discuss the impact of natural disasters and lack of available homeowners' insurance in local economies, including real estate markets, financial institutions and home construction. The panel will also present the consumers and other perspectives of this legislation. Our panel consists of Ms. Babette Heimbuch, who is President and CEA of the First Federal Bank of California, which specializes in single and multifamily real estate secured loans. Mr. Christopher Lewis is a Senior Manager of the Risk Management Group for Ernst & Young here in Washington. Ms. Kathy Whatley is a broker under Buck & Buck, Inc., a family realty firm in Jacksonville, Florida. Mr. Pierre Lanaux is President of Lanaux Construction in Lousiana.

Mr. J. Robert Hunter is currently the Director of Insurance at the Consumer Federation of America and a consultant in public policy and actuarial issues. Mr. Charles Brown is Vice President of

Baker Welman Brown Insurance and Financial Services. And Mr. Jordan Clark is President and cofounder of the United Homeowners Association.

Let me just say we have had an extraordinary day and a long one and we have been interrupted by votes, as all of you understand, in other issues that relate to Congress at this time. All of you have problems as well, and I am told Mr. Lanaux has a plane to catch at 5:00 o'clock. And if there is no objection of the other panel, I would like to begin with him, and then we will proceed in order as put forth.

Mr. Lanaux? Without objection all of your statements will be placed in the record fully, and you're certainly free to summarize if you choose. But please go ahead.

STATEMENT OF PIERRE B. LANAUX, PRESIDENT, LANAUX CONSTRUCTION, NEW ORLEANS, LA, ON BEHALF OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. LANAUX. My name is Pierre Lanaux, and I am President of Lanaux Construction. I am a builder from New Orleans, Louisiana and have been involved in the residential construction industry for over 15 years. I am pleased to appear on behalf of myself and the 190,000 member firms of the National Association of Home Builders.

I have been asked to confine my remarks to the Housing Subcommittee's print of H.R. 219. H.R. 219 was marked up by the subcommittee earlier this year and represents a combination of the elements of H.R. 219, as introduced, and H.R. 230, the Natural Disaster Protection and Insurance Act. This subcommittee print would create a Federal backstop through reinsurance to eligible State insurance programs in the event of a major catastrophic event.

The legislation is designed to foster accessible and affordable homeowners' insurance. H.R. 219 addresses the problems associated with the unprecedented number and magnitude of natural disasters the United States has suffered since 1989. For example, the massive property destruction resulting from Hurricanes Andrew and Iniki and Northridge Earthquake caused insurance companies to either discontinue doing business in these disaster-prone areas or to drastically cut back on the policies they insure, causing dislocations and severe consequences for homeowners and perspective home buyers.

States have already established or are in the process of instituting some form of insurance program or catastrophic fund. The National Association of Home Builders is pleased that H.R. 219, as currently crafted, contains no Federal mandate relating to State and local building code compliance and adoption provisions for disaster-prone areas.

At the same time, H.R. 219 begins to address the very real needs associated with the availability and affordability of homeowners' insurance for coverage of certain perils. For this reason NAHB can support the overall objectives of H.R. 219 and the process for moving the bill forward.

There are certain aspects of H.R. 219 on which NAHB has no formal position. My testimony is, therefore, confined to those provi-

sions relating to State hazard mitigation plans. These provisions would also have a direct impact on housing affordability and our livelihoods.

As noted above, H.R. 219 is silent on mandatory Federal code requirements. H.R. 219 addresses mitigation by requiring each eligible State insurance program to devote at least 10 percent of its net investment income to the State program measures to mitigate losses from natural disasters in that State. This requirement is conditioned upon the allocation not interfering with the actuarial soundness of the fund.

H.R. 219 would leave to the discretion of the pertinent States what type of mission programs they should adopt. NAHB agrees with that approach, which allows States to establish programs without Federal intrusion.

Traditionally, the health and safety of the general populace has been the prerogative of the States. This longstanding principle is well-founded as it is important to remember that each State/region is subject to differing perils, as well as varying degrees of risk. What might be an effective or necessary mitigation plan in Florida may not be an appropriate or effective plan in Louisiana or Texas.

With respect to the development of mitigation programs, NAHB argues that mitigation programs should not be focused exclusively on new construction, but that strategies should address existing structures which comprise the vast bulk of housing stock. Such programs could include emergency preparedness response programs, design and construction education programs, voluntary programs with insurance premium reduction incentives, enhanced code official certification requirements or a whole host of strategies. However, these programs should be left to the States to develop to address the particular nuances of their localities.

In my own State of Louisiana, for example, property damage from hurricanes and the consequent flooding is one primary source of concern. The cost of homeowners' insurance has dramatically increased since 1992. Louisiana has responded to this problem by establishing a disaster insurance program funded by voluntary participants who are either commercial enterprises or homeowners. These funds are only available, however, for high wind areas near the Gulf Coast. To my knowledge, there is no special mitigation program other than in enforcement of existing building codes.

Finally, I would like to add our support for a proposed change to H.R. 219. The National Association of Realtors, like the NAHB, is concerned that homeowners' insurance be accessible and affordable. We agree that the legislation should require a study evaluating the availability and affordability of insurance and the extent to which the State and private insurers are addressing the problem. Such a study was part of H.R. 230, and we hope that a similar provision could be incorporated into H.R. 219.

Again, I thank you for the opportunity to present these views of the housing industry on this important issue.

[The prepared statement of Pierre B. Lanaux can be found on page 370 in the appendix.]

Chairman LEACH. Thank you. We will note. That is appreciated, and I am sorry Mr. Baker isn't here to welcome a fellow Louisianian, but we are very honored with his work in the committee.

Ms. Heimbuch.

STATEMENT OF BABETTE HEIMBUCH, PRESIDENT AND CEO, FIRST FEDERAL BANK OF CALIFORNIA ON BEHALF OF THE WESTERN LEAGUE OF SAVINGS INSTITUTIONS

Ms. HEIMBUCH. My name is Babette Heimbuch, and I am President and Chief Executive Officer of First Federal Bank of California, headquartered in Santa Monica, California. My institution has 24 branches and holds in excess of $4 billion in assets. I am also a member of the board of directors of the Western League of Savings Institutions on whose behalf I appear today.

I would like to thank Chairman Leach for scheduling this hearing and giving this important public policy issue a thorough airing. I would also like to thank subcommittee Chairman Lazio, and Representatives Fazio, McCollum, Campbell for their leadership on this bill. Finally, we appreciate the constructive input the Administration is providing, especially the positive suggestions of Secretary Summers this morning. I very much value the opportunity to participate in this hearing on an issue which is of great concern to California lenders.

Depository institutions, whether they are located in seismically-prone regions like California, Missouri or Tennessee or hurricane areas such as Florida or the Carolinas or New York, face the potential of crippling losses should the traditional safety net of private homeowners' insurance fail.

I am here to tell you that that system is indeed failing. Over the last decade in California, we have experienced earthquake disasters that have caused many billions of dollars of losses. These events caused severe deterioration in the availability of earthquake insurance coverage. So much so, in fact, that in 1995 the California Department of Insurance reported that 95 percent of the insurance companies in the State would not underwrite new homeowners' coverage.

As you might imagine, the consequences of this insurance market failure were quite alarming to the financial institutions. As of the third quarter of 1997, there are 62 Federally and State chartered savings institutions in California which together hold some $195 billion of real estate loans, of which $185 billion are residential. FDIC insured financial institutions in California, savings banks and institutions, thrift and loan companies together hold nearly $330 billion in real estate loans.

To illustrate the magnitude of a failed insurance market, let us suppose the consequences of a major earthquake which causes $50 billion in losses. Such losses could translate into potential losses to homeowners, banks, thrifts of billions of dollars of property if homes were abandoned by their owners for lack of funds for repairs. And these problems would be exacerbated in a real estate market where home values and owners' equity are declining. Depository institutions would not be the only casualties. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation would also be at risk. Major losses would be incurred by the Federal Housing Administration and the Veterans Administration.

Finally the Federal deposit insurance funds would be placed at great risk. Indeed, it is not an exaggeration to say that the greatest risk to the funds protecting America's financial institutions is not financial collapse but large scale disaster.

I would like to illustrate some of these problems I have alluded to by describing the experiences of my own institution, First Federal Bank of California. My bank suffered losses in excess of $16 million from the Northridge Earthquake of 1994. That represents 8 percent of the bank's net worth. The bulk of those losses were from loans on apartment housing for low-income families. The majority of losses from single family loans were condominiums.

The coverage now being offered by the California Earthquake Authority would not have protected the bank against these losses. California has tried to solve the problem in its own way, but quite frankly the solutions in place that have already been described by others this morning are not enough.

The California Earthquake Authority has indeed alleviated the problem of homeowners being able to find insurance at any price, but they provide less coverage at a higher cost than what was available prior to the earthquake. Deductibles are higher and the program does not cover multifamily structures. Even more alarming, the fund cannot cover losses from an earthquake that causes more than $7.5 billion in losses.

But these problems are not of the CEA's making. The reality is that no State has the means of creating a program capable of handling the true mega-catastrophe. The CEA buys more private reinsurance than any other entity in the world, yet that coverage is only $2.5 billion and costs 50 cents out of every premium dollar collected.

We recognize that some have criticized H.R. 219 for its reliance on State-operated Government entities rather than the private sector. We are not experts on the pros and cons of funding mechanisms. But we do believe that there is a role for both State and Federal Government. Only Government can design and compel responsive insurance programs that provide adequate, affordable natural disaster insurance.

We urge you based on our experience to focus on these general principles as you proceed. Legislation should reflect good public policy. The development of a natural disaster program should be rooted in the principle that those who live in areas at-risk provide protection for themselves rather than on relying on the eventuality of Federal disaster relief.

A Federal solution is needed. An effective and comprehensive response to the risks posed by natural disasters is beyond the ability of any State. Insurance must be widely available at reasonable rates, adequate incentives to mitigate risks should be provided, and the program should include multifamily, as well as single family residences. This provision is already included in H.R. 219, and I urge you to make sure it remains in the bill.

Thank you.

[The prepared statement of Babette Heimbuch can be found on page 376 in the appendix.]

Chairman LEACH. Well, I thank you. And I am hard-pressed not to say that you are the second extraordinary female bank president from California who has testified before this committee recently.

Ms. HEIMBUCH. Thank you.

Chairman LEACH. We are very appreciative. And second, your comments about the implications of the big one on the deposit insurance funds had not been well brought to the committee's attention prior to testimony today, and I think is of signal significance. Thank you.

Ms. HEIMBUCH. Thank you.

Chairman LEACH. Mr. Lewis.

STATEMENT OF CHRISTOPHER M. LEWIS, SENIOR MANAGER, RISK MANAGEMENT GROUP, PEQA GROUP, ERNST & YOUNG LLP

Mr. LEWIS. Thank you, Mr. Chairman, Members of the committee for the opportunity to appear before you today to discuss this important topic of whether and how the Federal Government could improve our Nation's ability to finance the losses created by large national disasters.

As many of the other panelists have asserted, a strong economic and financial case for Federal involvement in improving the allocation of disaster risk in the United States can be made, especially in the areas of predisaster mitigation and the financing of large insured losses from catastrophic events. However, the need for Federal involvement is limited in scope and requires a very carefully designed program that does not interfere or distort the existing private insurance markets or regulatory structure.

To assist in this effort, I appear before you today on my own accord, not representing Ernst & Young, any client or interest group, to give you the benefit of my experience in studying this issue over the past several years, both as a member of the White House Working Group on Natural Disasters and as a private risk management consultant in the insurance industry.

Over the past ten years, the United States has witnessed a significant rise in the magnitude of insurance industry losses from natural disasters. In nominal dollars, nine out of the 10 largest U.S. catastrophes in history have occurred since 1989. In fact, after adjusting for house price inflation, insured losses over the 1989 to 1995 period totaled almost $75 billion, more than five times the average real insured losses during the prior four decades. More importantly, however, is the fact that one of the major factors driving this increase in disaster loss is a continued development in high-risk areas of the country, a problem that continues today.

Ultimately, the losses from natural disasters are always paid by only one constituency. That is the American people. However, the method through which the costs of natural disasters accrue to American people, either through taxes, insurance premiums or direct losses, is critical in optimizing the overall welfare of society.

For example, if all losses were financed through the Federal post-disaster assistance, which, in turn, is financed through general tax revenues, the general tax code would determine who bore the costs associated with disaster losses. In this case, the burden of financing and disaster risk would not be linked to the individuals creat-

ing the disaster exposures and individuals would continue to increase society's overall disaster exposure by building in high-risk areas, clearly an undesirable situation.

Alternatively, if disaster losses were completely financed up front through the purchase of insurance at an actuarially fair premium, individuals would have to factor the costs of insurance into their decisions on where to locate and how much disaster mitigation to incorporate into their building decisions. As a result, individuals would have an incentive to build in lower-risk areas of the country, reducing the growth in the country's overall disaster risk and optimizing the allocation of risk in the economy.

Ideally, a comprehensive system for financing catastrophic losses would create strong incentive for individuals to mitigate or reduce their exposure to loss from disaster events, would improve the efficiency and effectiveness of how losses that do occur are financed, and would provide for quick response of assisting individuals that do need assistance in the wake of a disaster.

The question before the committee is how can Federal policy help foster a market-based solution that meets these objectives? Addressing this question requires a closer examination of the problems within the insurance markets that are preventing such a solution today.

In financing property/casualty disaster risk, insurance companies are the primary intermediary in the U.S. economy. Individuals living in disaster-prone areas are exposed to considerable losses from disaster events. In providing disaster insurance, an insurance company offers to assume a portion of this risk in exchange for a premium.

After accumulating these policyholder positions, the insurance company can diversify its disaster risks through its pooling, risk identification, risk identification and segregation, risk monitoring and risk mitigation.

The insurance company's ability to diversify insurance through polling is extremely effective when risks are independent and often identically distributed like fire insurance. However, in the case of large idiosyncratic risks, like disaster insurance, where multiple policies are affected by the same event, the benefits of pooling are significantly less; for these events diversification must occur across time, with insurers financing disaster exposure through the purchase of reinsurance, the issuance of capital market securities or through stockholder equity.

For most disaster risks, the problem does not reside in whether the events are insurable, but whether the insurance company can establish an effective mechanism for accomplishing this intertemporal smoothing of claims. Historically, insurance companies have relied largely on reinsurance and self-insurance. However, given limited liability and exposure constraints, even large industry and reinsurance companies lack the capacity to accomplish the intertemporal diversification of loss that is needed.

In response, considerable attention has been focused on creating alternative market mechanisms, including a focus on the development of capital market securities. The prospect of finding another source of capital through disaster derivatives or securitization was

alluring to reinsurance firms because of the sheer size of the capital markets.

Catastrophe securities also were seen as offering advantages to institutional investors. Recognizing these advantages, insurers in investment banks have made considerable investments in developing new capital market products that are attractive to both insurers and investments.

Following several years of lackluster performance, the catastrophes securities market registered significant progress as a new asset class in 1997. During the year the market registered over $1 billion new issuances, including transactions by USAA, Swiss Re, Winterthur and Tokio Marine.

All indications suggest that 1998 will exceed the $1 billion mark set in 1997, and if the catastrophe market continues to follow the evolutionary path of other asset-backed securities markets, new issuance could grow significantly in the next five years.

Notwithstanding this potential, the security market faces many obstacles that need to be overcome before a fully developed market can be established. For example, the market lacks a standardization in risk measurement in structuring, the lack of a generally accepted index on which to base payouts, and sometimes excessive transactions cost when compared to reinsurance. Even if the private capital market is able to grow over the next several years, catastrophe securities are unlikely to provide the answer to financing truly catastrophic events.

Given the shortcomings within the existing markets for financing disaster claims over time, insurance companies, reinsurers, States and other constituents have raised the issue of a Federal role in the financing of disaster insurance. Historically, the insurance industry has a post-Federal intervention in the insurance marketplace. However, the large-scale disruptions caused by Andrew and Northridge have prompted many members of the insurance industry to call for some form of Federal assistance.

Evaluating the potential role of the Federal Government in financing catastrophic risk is an important issue in examining the current problems facing the insurance industry and in the financing of catastrophic risk more broadly. Two current shortcomings in the allocation of catastrophe risk become apparent, the lack of internalization of risk and individual decisionmaking, and the absence of a mechanism that would allow insurance companies to smooth claims over time; in addition to cost effective mitigation, the encouragement of actuarially priced insurance in one mechanism for improving the internalization of risk at the individual level. However, this requires insurance companies to have the capacity to offer those policies without jeopardizing their solvency.

To develop a Federal program that can expand the capacity of the insurance industry without interfering with the regulatory framework of the insurance industry while continuing to support innovation and development in the insurance and capital markets presents a considerable challenge. Equally as difficult will be developing an approach that is narrowly defined and targeted at providing a mechanism for intertemporal risk diversification without encouraging additional risk-shifting to the Treasury. In this respect, the Federal Government's unique position in the debt markets is

a great advantage. However, the difficulty is designing a program sufficiently targeted to only utilize this unique borrowing authority.

Other issues that such a program would have to face would be avoiding any replacement or displacement in the insurance industry, including favoring one segment of the industry over other segments, setting appropriate attachment points and caps in the Federal Government's overall exposure, maintaining the current State regulatory framework with the critical link between State regulation of solvency, insurance rate approval and the State guaranty fund structures maintained, fostering the development of innovation in the capital markets, pricing the program at normal market rates, avoiding the creation of another Federal bureaucracy, and creating a budget-neutral program are all important obstacles.

In conclusion, there is a strong economic and financial argument for the Federal Government to play a role in financing catastrophic risk; however, the challenge for the committee is how to correctly define this role so as to encourage cost effective mitigation in the development of a narrow mechanism that would allow the insurance industry to smooth large disaster claims over time.

Mr. Chairman, I thank you for the opportunity to appear today. And I welcome any questions after the rest of the panelists.

[The prepared statement of Christopher M. Lewis can be found on page 378 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Lewis.

Ms. Whatley.

STATEMENT OF CATHERINE WHATLEY, PRESIDENT, BUCK & BUCK, INC., JACKSONVILLE, FL, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

Ms. WHATLEY. Thank you, Mr. Chairman, for the opportunity to present the views of the National Association of Realtors on H.R. 219. We want to thank you, Mr. Chairman and Chairman Lazio, for your leadership on this issue of the National Disaster Insurance, and we also want to thank Congressman McCollum in his efforts that he has taken to find a solution that has plagued the State of Florida since 1992.

I am Cathy Whatley. I am a realtor from Jacksonville, Florida. I work with buyers and sellers of homes every day, except today. I am here today. I am also the 1998 regional vice president for the National Association of Realtors for Region 5. That encompasses a number of southeastern States, as well as the Virgin Islands and Puerto Rico.

The deterioration in the availability and the affordability of homeowners' insurance in disaster-prone areas is an issue of very real concern to the National Association of Realtors. Many of our members specialize primarily in the business of assisting sellers and buyers in residential real estate transactions.

It is this business focus that motivates NAR's interest in the resolution of this problem. Although I am testifying today on behalf of the real estate industry, I can't emphasize enough that the ultimate victim of the homeowners' insurance crisis is the consumer who is frustrated in his or her attempt to realize the dream of home ownership. And when anyone, whether it is a young family or any other potential homeowner, is precluded from owning a

home because homeowners' insurance is either too difficult to obtain or too costly to afford, we all suffer the consequences. The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market.

Not only does it impair all the market for single family detached homes, but the condominium, co-op and rental markets are affected, as well as new home purchases, resale transaction and housing affordability are negatively impacted in several ways.

First, homeowners' insurance is a necessary component in securing mortgages when buying a home. If a potential home buyer is ultimately unable to obtain the required insurance, because the insurance is either unavailable or unaffordable, the sale will not be completed. As a result, credityworthy potential home buyers are priced out of the market. In a recent NAR survey, respondents reported that an estimated 2450 transactions fell through because of difficulty in obtaining disaster insurance. Seventy-five percent of those respondents cited that it was unaffordability for the reason.

Second, homeowners' insurance is tied directly to the cost of owning a home. If a homeowner is unable to maintain insurance required by the mortgage lender, the mortgage is in default. Disaster insurance coverage is optional. Potential buyers may choose not to purchase a home simply because the insurance they consider essential is too costly; others may choose to go unprotected.

Third, insurance costs impact rental rates. Insurance costs incurred by landlords are ultimately passed on to tenants. Consequently, increased insurance costs results in higher rents.

The National Association of Realtors supports H.R. 219 for several reasons. It protects against mega-catastrophes. State programs that have been created to address the problems are well-intentioned first steps, and homeowners' insurance is currently available in these States. However, neither State disaster programs nor the private insurance industry have the capacity to cover the risk presented by mega-catastrophes far more damaging than Hurricane Andrew or the Northridge Earthquake. The creation of a Federal disaster reinsurance program today will help prevent future interruptions in the availability of homeowners' insurance.

H.R. 219 also promotes fiscal responsibility. By establishing a program which promotes available and affordable insurance coverage for those at risk of property losses from a natural disaster, the bill would minimize future unforeseen disaster assistant expenditures and keep us on course to balance the Federal budgets. It is time to begin planning for future disasters and provide insurance to those at risk so that they can be adequately prepared when that time arrives.

NAR's primary concern is the availability of affordable homeowners' insurance. Any Federal program that is created must be designed to achieve that goal. To that end, we suggest that H.R. 219 be amended to require an agency study evaluating the availability and affordability of insurance and the extent to which States and private insurers have responded to the problem, we must safeguard the cornerstone of the American dream.

NAR supports the Federal response to the disaster insurance crisis which helps to make the dream of home ownership a reality for more and more Americans. We urge the Banking and Financial

Services Committee to take action this year on this important issue.

Thank you, Mr. Chairman.

[The prepared statement of Catherine Whatley can be found on page 387 in the appendix.]

Chairman LEACH. Thank you, Ms. Whatley. And I know Mr. Foley wants to welcome you.

Mr. FOLEY. Welcome to my real estate colleague to Washington, DC. and for her insightful testimony in support of the bill. I think it is vitally important for all of us in Florida and all of us in the Nation to establish this as a significant part of public policy. So I again thank Cathy for joining us, and thank the Chairman for his indulgence.

Chairman LEACH. Thank you, Mr. Foley.

Mr. Hunter.

STATEMENT OF J. ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER FEDERATION OF AMERICA (JOINT STATEMENT WITH CONSUMERS UNION)

Mr. HUNTER. Thank you, Mr. Chairman. It is a pleasure to be back in this room where I was Federal Insurance Administrator and was politely browbeaten many times from that chair where you are sitting. I was Federal Insurance Administrator during the 1970's and ran the National Flood Insurance Program, which could serve as instructive as you design the bill, and it is good that this committee has that experience and expertise.

I also served as Texas Insurance Commissioner, and so I am interested in how this will impact the insurance industry, but also I am here representing both the Consumer Federation of America and Consumers Union to raise the issues from a consumer perspective.

I want to congratulate the various people that have been congratulated several times, Mr. Lazio, you, Mr. Chairman, and Mr. McCollum. A lot of good things have happened because of the Congressional interest over the years in this issue. The Wharton School is conducting research into the kinds of questions that have blocked passage of the bill historically, such as the impact of hypothetical large catastrophes on the market and the capacity of the private sector to handle the risk, and so on. They have also been doing a great deal of research into the securitization of the catastrophe risk, which has a lot a potential.

FEMA has prepared a national mitigation strategy, as a result of their concern and your concern. It is a beginning, but it requires enforcement. As you know, in Florida had there been enforcement of the existing building codes, estimates are that at least 40 percent of the Hurricane Andrew damage would have been avoided in Florida. The American Red Cross has incorporated natural disaster loss mitigation as a core program now in its work. And most property casualty insurance companies have created and are supporting the Institute for Business in Home Safety, which is working on mitigation issues.

And then there is the Public-private Partnership 2000 initiated by 19 Federal agencies and the IBHS, which is a series of 14 educational forums which we are in the middle of right now on the

questions that you are here discussing. So there is a lot, as a result of your efforts, that is already going on in the marketplace of ideas and thoughts and so on. So that is very good news.

Additionally, there is some bad news. The bad news is we have a system in this country that has an imbalance in it. I have data attached to my testimony that shows that wind is pretty much covered with private insurance, and places like Texas and Mississippi and Louisiana are paying $7.00 or more per-thousand dollars of home value to protect themselves from that by insurance. And then there is a chart that shows that most wind is covered by private insurance and there is very little Federal disaster relief.

But there is a lot of Federal disaster relief, and there is considerable cross-subsidies between different States and different parts of the country, which I point out in my written testimony. The annual cross-subsidies from disaster relief range from an average per household subsidy to North Dakota of $104, to California of $100. But States like Connecticut and New Jersey and New York are paying in a lot more into the disaster relief system, because disaster relief isn't charged like premiums. It is not risk-related. There tends to be these cross-subsidies, and so it is very important for any plan that you work on to figure ways to reduce those taxpayer subsidies over time. You are always going to have taxpayer emergency costs after a big disaster, but the idea of moving toward more insurance and disaster relief is a good one.

There are certain principals that consumer groups believe should underlie any good bill. The first is that adequate insurance protection to the public should be a requirement of Federal backup. You should make sure that the bill has some requirements that adequate insurance be available to consumers in these high-risk areas for the very reasons you have just heard about.

There has been a very strong move toward very weak coverage. The California Earthquake Authority has a 15 percent deductible. I was the actuary that worked for the State of California analyzing the California Earthquake Authority. The average payout expected from all earthquakes is only about 40 percent. That means 60 percent is left over for the homeowners to bear, and the taxpayers.

And we have the very odd situation when you have these high deductibles where the Federal Government comes in for disaster relief below the insurance. That is not a good idea. The Federal Government should be coming in at the high level, not at the low level. So moving in the direction of not paying disaster relief below deductibles would be a good idea.

The second principle is that strong mitigation should be a component of any bill. To back up insurance in a high-risk area of the country without controlling against unwise new construction is going to increase taxpayer liabilities as well as insurance rates in the long run, and you need to make sure that you are not encouraging unwise construction.

We have learned from the flood program, which I administered, that when your rate is too low, people build, and that happened on barrier islands while I was administrator. We had an error in our rates, they were too low, and people rushed in to build as a result of it, and that was a very bad thing for the country. So you have to make sure that there is some kind of mitigation.

New construction should be rated at full risk rates to make sure that construction is safe. You should absolutely require that at least new construction be rated at full rates.

Then the enforcement of building codes is an important thing that needs to be considered. Again, 40 percent of the claims from Hurricane Andrew would have been eliminated had the current building codes in that area been enforced, according to the research. We need incentives for existing structures to retrofit, particularly in earthquake areas. One of the problems with the CEA is there is no real retrofitting discounts available today.

Now, third, we should maximize the private sector approach. We have heard that all morning. There has been an amazing growth in surplus even in the years of Hurricane Andrew and Northridge. The surplus of the insurance industry went up dramatically. There has been $60 billion of disasters in this decade, the most in any seven-year period in history. And yet the insurance industry's surplus has more than doubled.

We need to take that into consideration in setting the triggers. A.M. Best calls the industry now excessively capitalized. Catastrophic reinsurance rates have been falling dramatically, and there are alternative methods and sources of backup such as the securitization of risk.

Finally, we need to learn from the National Flood Insurance Program and incorporate those lessons.

H.R. 219 fails to meet these four key principles in several key respects. First of all, the bill increases taxpayer liability, and exacerbates the cross-subsidies already inherent in disaster policy, because the bill has no goals for mitigation, no real plan to reduce the Nation's losses, and that is a serious problem.

The bill has no accompanying plan to show how the taxpayer will fare year by year under the bill's provisions. The goal ought to be to reduce the taxpayer liability over time, and it ought to be a plan that would show if this bill was passed how the taxpayer ultimately would have a lower, not a higher liability. The bill triggers, as low as $2 billion, greatly impedes private market developments. In my testimony I do an actuarial calculation where I think the trigger should be $40 billion, and the $37 billion you heard from earlier testimony by RAA is pretty close to that.

The bill sets up no standards for State pools, thus pools, such as the California Earthquake Authority, which actually increases taxpayer liability, are covered. I think there should be some standards for how the pools should look to gain federal taxpayer back-up.

And then the bill does not guarantee insurance to anyone. It only guarantees insurance companies will be able to tap the Treasury in the event of a large event. So the Consumer Federation and Consumers Union oppose H.R. 219 as it is currently drafted. And most insurance companies don't support it, except for a few giant insurers like Allstate and State Farm, who aggressively marketed to homeowners in high-risk areas in the 1980's, creating what the Florida Academic Task Force termed as an oligopoly in the hurricane-prone areas of Florida.

H.R. 219 interferes with the private market, it does not make insurance available. Congress can do much better. You can adopt a plan that lowers the risk of death in property damage through

mitigation. You can develop an integrated approach to insuring natural disasters. You can minimize Federal involvement and maximize private solutions. You can set the Nation on a course where ultimately the taxpayer will be off the hook for all but the emergency relief and shelter aspects of natural disasters. When we have a situation like we had this morning, where the representative of the Florida insurance department was unsure whether he would even buy the coverage if H.R. 219 passed, it makes you wonder, because if he isn't going to buy it, who will?

When the representative of the California says the problem is not that he wants reinsurance because he can't get it but he wants to cut the cost of reinsurance that he's getting from the private market, when the data from the California rate hearings shows that the California Earthquake Authority didn't buy reinsurance from the low bidders. There is a serious problem.

So, I thank you. I think the country is really moving forward, and I encourage you to consider major amendments along the lines of what I suggested.

[The prepared statement of J. Robert Hunter can be found on page 392 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Hunter, and your thoughts will be thoroughly reviewed.

We have a problem with another vote in the floor. Before turning to you, Mr. Brown, are you going to be more than one or two minutes? Then I think out of fairness to you, we will recess at this time and return in 10 to 15 minutes. The hearing is in recess.

[Recess.]

Chairman LEACH. The hearing will reconvene. We left off just before hearing from Mr. Brown. Mr. Brown is recognized.

STATEMENT OF CHARLES T. BROWN, VICE PRESIDENT, BAKER WELMAN BROWN INSURANCE AND FINANCIAL SERVICES, KENNETT, MO., ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA

Mr. BROWN. Thank you, Mr. Chairman. I appreciate the opportunity to address the committee on natural disaster legislation.

My name is Charles Brown. I am Vice President of Baker Welman Brown Insurance in Kennett, Missouri. I am an independent insurance agent. I have the privilege of representing hundreds of homeowners in my community with all different types of homes and all different values of homes. I am testifying today on behalf of the Independent Insurance Agents of America.

I live in a nice little town, but unfortunately, it is located in what is predicted to be one of the worst affected areas of the New Madrid fault. We have our problems just like California and Florida when it comes to markets and insurance availability. In fact, ripples and tremors from the enormous potential for damage in the New Madrid fault area, coupled with the financial impact that Hurricane Andrew and the Northridge Earthquake had on our insurance companies, are still being felt by my clients and all the homeowners in eastern Missouri and the surrounding States of the New Madrid fault zone.

We have seen our market for earthquake coverage on homeowners' policies dwindle at an alarming rate. This change has been a lot less dramatic than the market problems in Florida or California, but I want to stress that the changes in our market have been no less real to my clients. Let me explain what is going on in Missouri. It is a little bit different.

First of all, we have seen companies actually in our market simply withdrawing, canceling agencies, canceling contracts. One company, American Family, which is a large writer, canceled all of their agents in southeast Missouri. They did this several years ago. They still haven't appointed any agents in my area.

A personal example: My agency was visited by a large national insurance company in 1997, and that company asked us to basically nonrenew all of our homeowners' insurance policies. They said they had taken a look at the earthquake risk in southeast Missouri, and there just wasn't any way to charge enough premium for the exposure.

Another agency located in southeast Missouri had similar problems. One of their companies they represented told them they were going to cancel their contract because of poor losses. The agency owner happened to be a friend of mine. He said, "Well, I haven't had poor losses. What's the problem?" The company representative finally said, "Well, really we've just got too much earthquake exposure. If you'll cancel all your homeowners' policies, you can keep the contract."

We do have, unfortunately, companies that are taking those types of actions. But the most widely used tactic we have seen in our homeowners' marketplace that companies are using to exit the market is by simply increasing the cost of their policy. A company can easily see their business canceled by using this tactic.

Allow me again to share a personal example of what occurred in my agency. We had a regional company that was owned by another large national insurer. That national company decided to absorb this regional company. In the process, they increased the rates on all their homeowners' policies in southeast Missouri and northeast Arkansas, where they wrote business, by over 100 percent. Needless to say, when somebody who was paying $500 got a bill for over $1,000, they went shopping. It has caused lots of problems.

Our Missouri Department of Insurance has done several studies on this. The first one, they did back in 1996. This just shows you how fast our market has been changing: Their headline was "Statewide Earthquake Insurance Market Relatively Stable." The next press release in August of 1997, their headline was, "Earthquake Insurance Rates Up Sharply in Boot Heel"—where I live—"Coverage There Falls Off".

That leads me to one of my next concerns about our marketplace, that Mr. Hunter alluded to; that is increasing deductibles we are seeing companies use. It used to be we saw deductibles from 2 to 5 percent. Now we are seeing usually 10 percent, 15 percent, 25 percent. We have also seen companies limit coverage to just coverage on the building and limited coverage on the contents. I guess my question is, where are those homeowners going to get the money for those higher deductibles?

With all this in mind and as last year's president of our Missouri Association of Insurance Agents, we decided to form a task force to look into what we could do in our State. We have had several meetings. We have had involvement with all of our major personal lines insurance companies—State Farm, Allstate, Farm Bureau, Shield of Shelter—all the major markets in working toward some type of program, similar to what Florida has for their hurricane fund, to handle earthquake insurance in Missouri.

The basic reason we looked at this is because we weren't sure if we were going to see a Federal solution. After today's testimony from everybody, I am a whole lot more hopeful that we will. But we are working in Missouri. I want you to know that I think other States are seriously looking at what they can do to help their citizens with this natural disaster problem.

I just want to close by saying that I think we have a choice. The way I look at it with my clients, when I talk to them, those clients that tell me, "Charlie, I just can't afford it," and I ask them, "Well, you know, I'm a salesman. Well, what are you going to do?" They say, "Well, I figure Uncle Sam will bail me out later on." I think that is our choice. We can do something now or we can wait and just bail them out later on. Thank you.

[The prepared statement of Charles T. Brown can be found on page 427 in the appendix.]

The LEACH. Thank you, Mr. Brown.

Mr. Clark.

STATEMENT OF JORDAN CLARK, PRESIDENT, UNITED HOMEOWNERS' ASSOCIATION

Mr. CLARK. Thank you, Mr. Chairman. I am going to just give an overview of my statement and some my observations.

I represent the end product of anything that is decided here today, and that is basically homeowners. Homeowners have the most to lose or gain no matter what is decided by Congress and the Administration. They can lose their house, which is their most valuable possession both economically and socially. Also they lose a lot of tax money since we pay about 90 percent of the income tax. So we get the double whammy.

We have been involved in this issue for about nine years, the age of our association. We have worked closely with Senator Stevens, we were one of his four core group members, at his attempt to solve the problem. I admire you and I admire Congressmen Lazio and McCollum for taking the saddlebag after the untimely death of Congressman Emerson and the fact that we didn't succeed with the Stevens attempt, although I think we made progress and at least called attention to the issue.

It was very encouraging to hear Assistant Secretary Summers move a little bit off the dime as far as his acceptance of excess of loss. Had he given that testimony two years ago, maybe we wouldn't be sitting here today, we would already have passed a bill.

I hope you are successful getting some paperwork out in replacement of principals. There are three possible solutions, as we see it, to solving the disaster insurance problem, which others have basically outlined, so I don't have to tell the committee or anybody else here how bad the situation is or could be. The liability out there

not only for homeowners, but for, I think, the financial markets including Fannie and Freddie and FDIC was mentioned today, but I think Fannie and Freddie, especially in the secondary mortgage market, have some liability out there and should be very interested in what is going on.

The three solutions we see, the possible solutions are not mutually exclusive, are rolling the problems with earthquake and wind disasters into a flood-type program. Since the flood insurance program has many critics, I don't think politically that is feasible today, although I think the flood program could work better, as you well know. The other possible solution is the favorable treatment of reserves as far as the insurance companies are concerned.

As far as taxing the reserves, two years ago I would have said that is a dead issue. I think, as time goes by, maybe that is where we are going to end up. It may save the taxpayer a lot of money. It is probably the most acceptable as far as the insurance industry is concerned.

The third is excess-of-loss contracts, which is a creation basically of Chris Lewis; he doesn't look that old, but I think he was the father of this about five or six years ago. That is one way—that is nothing more than reinsuring the insurance industry and/or the States with State programs. That is, of course, the essence of H.R. 219.

There is no question that whatever solution we come up with, it is a national solution. Disasters do not know State boundaries. They do not discriminate between State treasuries or the Federal treasury either, I might add. So we have to come up with a Federal solution.

Those who think that people in California should pay for their own problems and people in Florida, and so forth; I think we just don't operate that way in this society and with our Government. Until we become a totalitarian Government, we are not going to nor should we. So we have to realize and perceive that if it is a national problem, it needs a national solution.

Also, I might add that we pay for insurance. We have crop insurance. People in Scranton pay for that, people in Sacramento pay for it, and so forth. So there are pretty good insurance programs which we cross-subsidize.

Unfortunately, the State programs that exist now don't meet another criterion which I think must be there for successful programs. That is, that any program that we decide on has to be actuarially sound or it is not going to fly in the market; it has got to be affordable to the customer or it is not going to be purchased, and it has got to be reliable. If we get a piece of paper saying, I owe you, after the storm hits Miami, it doesn't really do me much good as a homeowner.

The California Earthquake Authority was created basically to disconnect the offering of model P&C coverage with earthquake coverage. We knew when we supported the CEA that would not solve the earthquake insurance problem in California. The deductible is out of reach. Fifteen percent of insurable coverage is about $40,000 for most California homeowners. If they don't have that, they are not going to be able to reach the insurance itself. So they make the decision not to buy it. Less than 30 percent of Califor-

nians are in that program, substantially less from what I heard this morning. So it is well intended but it is really not working.

Florida is substantially underfunded. It will work if there is no hurricane. We hope there isn't. But if there is, we have all got a problem. In Hawaii, the same.

So H.R. 219, I think, is an excellent step forward. I think since it backstops State programs which are not working—and it is not H.R. 219's fault that they are not working; I just don't think they are working the way they should—one has to wonder whether it will work or not. But I don't want to throw water on it because I think that Congressman Lazio and others, including yourself, have worked hard.

This is not an easy issue. We have got a lot of stakeholders with a lot of interests. We hope that you will continue to go forward.

I was the last witness at the Stevens hearing. I hope I am not the last witness at the House's attempt to solve this problem in this Congress and the next Congress.

We will support H.R. 219 as far as trying to make it better. We will gladly work with the Chairman, with Mr. Lazio and the dedicated staff, I might add, to try to solve this problem. I think we can bring some experience and at least some of the work that we have had committed on this over the last nine years. We have made some mistakes, but I think we also know where to go on it.

I appreciate the opportunity to speak once again on the subject matter. I suppose we will be back again in the future. I look forward to working with you on coming up with a reasonable solution.

[The prepared statement of Jordan Clark can be found on page 435 in the appendix.]

Chairman LEACH. Thank you very much, Mr. Clark. You have a long history on this issue. That is appreciated.

Mr. McCollum.

Mr. MCCOLLUM. Thank you, Mr. Chairman.

Mr. Brown, do you expect Missouri to enact a catastrophic fund, a CAT fund or is that in the cards?

Mr. BROWN. Well, that is what I hope. That is what we are working toward. We have politics there just like we do here. But we do think that is a good possibility. We have a lot of interest within our industry in the State. We think they recognize there is a problem. Our goal is to introduce legislation for this next session of the Missouri General Assembly. We are going to find out in a hurry.

Mr. MCCOLLUM. This morning Mr. Summers testified that he thought that the base bill, H.R. 219, ought to be modified to provide for the sale of excess-of-loss contracts to all entities on an unrestricted basis. Right now the way, as you probably know, H.R. 219 works is that for those States that have CAT funds, they buy the contracts and there is a certain specified method of doing it; and then there is an auction possibility that the State would run within certain very narrow parameters.

Do you have a problem with that modification? Would that make a difference in Missouri one way or the other, whichever route, either we stuck with the bill as it is now or do what Treasury seems to want? Are you familiar with these XOL contracts?

Mr. BROWN. A little bit. I am an insurance agent, not a reinsurance expert. But from what I understand about it, I do have a little

bit of concern with the auction method. To be quite frank with you, that is one of the reasons we thought we would like to see a State program.

My fear with the auction was that we might see some insurers take advantage of it and other insurers not take advantage of it. The problem that presents to me and to my clients is, it might be that my companies don't—for one reason or another, they are too small or they are too big to qualify under—when you are looking at classifying as a small company in the auction process.

One of the reasons we are looking at a State plan in Missouri is that it has something for every insurance company, period. So we get everybody involved. In a way, I look at it, we are guaranteed to do something about the market.

Mr. McCOLLUM. I can see why you want to do that. I, at the same time, know that we are dedicated to crafting whatever we do here that provides a wide variety of participation. We don't want a narrow participation, either.

Mr. BROWN. Oh, no. I think both methods ought to be there, because I think there are companies in other States where the political realities are, there is not going to be any type of State plan to deal with their catastrophe

exposure.

Mr. McCOLLUM. Like Tennessee or Arkansas?

Mr. BROWN. Possibly.

Mr. McCOLLUM. I hear they are not likely to do that.

Mr. BROWN. They may have their difficulties in putting something together because of the location of the fault and the population centers that are involved; and we happen to have St. Louis in ours, which gives us a lot more leverage, political leverage, in our Missouri General Assembly. I think you need to have both so that you can truly help everybody.

Mr. McCOLLUM. Ms. Whatley, you are a Floridian here, but I have got to ask you this, wearing your other hat as the official representative today of the realtors.

As I indicated, Mr. Summers testified this morning. You probably heard him; I don't know if you were here for that, but he felt that the legislation should be modified to provide—and I keep reading this so I get it right—"for the sale of excess-of-loss contracts to all entities on an unrestricted basis rather than the kind of restriction in the bill right now."

Does that make any difference, from your perspective, whether we modify that, or not as long as we got a bill out that the insurers would participate in?

Ms. WHATLEY. Congressman, I think we would support any Federal program that would effectively address the availability and affordability of the insurance. We do see the problem being so large that we think it is going to take the Federal Government coming in to help to provide some stability to prevent future discrepancies. But the vehicle by which you all—I am not an insurance expert, nor is the National Association of Realtors.

Mr. McCOLLUM. That is fair enough.

Mr. Lewis, you worked some time ago on the subject of these excess-of-loss contracts. Do you agree or disagree with Mr. Summers' comments this morning that H.R. 219 ought to be modified to pro-

vide for the sale of excess-of-loss contracts to all entities on an unrestricted basis?

Mr. LEWIS. I would agree with that comment. I think it would build in a little bit more efficiency in the distribution of the protection to companies on a needs basis. It would allow companies to actually bid for and get the coverage that they need, and it would allow more competition within the market, between States and between companies, so that that coverage does in fact get out to the companies and the homeowners that need that protection.

Mr. MCCOLLUM. What do you say to the concerns Mr. Brown expressed, worries that insurers naturally might have, the agents might have, that companies wouldn't participate in an auction? I know we have had quite a few of them say, "We would." In fact, we have spent a lot of time, Mr. Lazio and I have, working on that question. But what do you say to his concerns?

Mr. LEWIS. I think that they are legitimate concerns. I think that it gets to the nature of how you structure the auction. We have not spent a lot of time discussing how an auction would be structured to accommodate the needs of smaller insurers. But that is something that is an important thing to focus on so that it can be designed in a way that meets the need of small insurers, large insurers, reinsurance companies and States.

Mr. MCCOLLUM. Can you succinctly state how you do that?

Mr. LEWIS. First of all, there is going to be—I think Deputy Secretary Summers talked about the benefits to reinsurance companies that expands their capacity to provide reinsurance to the smaller companies. Reinsurers are providing the bulk of the protection for smaller companies already. To the extent that they get additional capacity through an XOL program, they will be able to provide that capacity on down to smaller companies.

Other options include letting smaller companies have, I wouldn't want to call it preferential, but independent ability to enter the auction, so that they would in fact be competing with their peers as opposed to larger companies. But again the details of how you actually work that out would have to be——

Mr. MCCOLLUM. I know my time is up, but Mr. Nutter is saying that reinsurance companies would buy these XOL contracts. Is how you see it, indirectly that is going to benefit the small insurance company? That is part of what you are saying, isn't it?

Mr. LEWIS. That is correct.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman.

Chairman LEACH. Thank you, Bill.

Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman. I am sorry I missed most of the hearing today, because this is an issue that is very important and close to my heart. I would like to just make some observations that I hope the committee Chairman and subcommittee Chairman will take into consideration.

First and foremost, I find myself on the defense; I feel I should be on the other side of the aisle now, because suddenly the Government is asked to come and solve a problem and create a program to solve a problem instead of reliance on the free market system. Although I am not remiss to admit that in some instances I think the market, free market, does not solve all problems, clearly I do

not think that the Government should jump in headfirst into this type of program unless several things happen.

One is that there be some form of equity out there for all taxpayers and that this is not just an attempt to put off the burden in States like Florida, Texas, California or the East or West Coast States simply because they find themselves in a problem. Why should the market work? And what would it mean if the market worked?

Let me give you an example. From the best that I can recollect, if we took Hurricane Andrew, I believe the damage caused by that hurricane was $24 billion. It is estimated that if that storm had struck the Miami area, 20 miles north of where it did strike, the damage would have been in excess of $48 billion. That is a huge amount of money that we will be called upon to pay if we get into the secondary insurance market.

But the whole purpose of insurance, or risk, if you will, and the need for the marketplace to prevail is that at some point in this country, we are going to have to decide that people are going to have to build according to certain types of codes and safety, certain mitigation programs will be put in place.

It seems to me self-evident that we ought to look at the flood insurance program and recognize that we now have people that build on the outer coastal islands, and periodically, every five to ten years, they get wiped out; they go to the Federal Government, they get their insurance and they rebuild. We do not have the political will in the Congress nor do the States or communities have the political will to bar building in these high-risk areas.

What are we doing in hurricanes and earthquakes? The East and the West Coasts, we are now under this type of a program, subsidizing otherwise capital that would not flow to these areas.

I have seen a projection that if Andrew were to strike Miami 20 years from now, 20 miles north of where Andrew came in, the damage would be in excess of $150 billion. Why? Because we are going to be writing a lesser cost to allow capital to invest in Miami—great weather, great location—but why shouldn't we encourage that capital to be invested in Kokomo, Indiana, instead of Miami where it is at a high risk? And what we are doing is upsetting the marketplace and the balance.

Normally capital would not flow and expend its investment in Miami if they had to carry the burden of what insurance in the marketplace would require. That is what nature forces the market to do, discourage people from their own stupidity or foolishness.

Here, when we move into a secondary operation as a Government, we are encouraging the market not to operate and therefore no force of nature encouraging people to make more intelligent financial risk decisions as a result of disasters, only because we have interpleaded the Federal Government to be the responsible party.

In one instance, the most dangerous thing of this principle, I believe, is that, one, we have lost faith with the marketplace; two, we have caused a disconnect to occur; and three, we are fundamentally upsetting the natural nature of how this country should grow and develop. We are discouraging people from making the investment in Kokomo, Indiana, we are encouraging them to put their investment in a risk area in Miami, the risk of disaster, but certainly a

more financially rewarding investment by going into the Miami area.

If you think in terms of a building or an apartment, $10 million, where would you rather put it if you were an investor, in Miami Beach or would you rather put it in Kokomo, Indiana? You would have to be a fool not to say Miami Beach. The only time you will make that decision, however, is if the Government picks up the risk of that high cost of insurance; or else you won't be able to sell that property or mortgage that property because you won't be able to cover that risk. That is what the natural market would do.

We are perverting the natural market from operating and, therefore, subsidizing people to make improper investments which will put greater capital at risk of disaster, and two, really imbalance the population in the development of this country.

Mr. McCOLLUM. Will the gentleman yield on that?

Mr. KANJORSKI. Certainly.

Mr. McCOLLUM. I respect him a great deal. One of the things I just want to make sure he understands is that what Mr. Lazio is trying to create, and certainly what I want to modify to the degree necessary to make sure it is true, is that the insurance companies pay premiums into the fund and that the taxpayers don't subsidize this in this instance.

It is a lot different than the flood insurance program. I hope you are aware of that. I really want to be sure you know that that is what we are trying to do.

Mr. KANJORSKI. I have worked with this. But I think that both of us are not naive enough to realize that once we provide the secondary insurance here and create these funds and with the further development of wealth in this country and risk, that the Government is never going to get out of this program. If local communities can't require good building codes, if they can't implement mitigation programs to reduce the exposure of the risk, I don't know why you think the will of Congress is any stronger than that. We are going to weaken and subject all the taxpayers of this country to underwrite forces that oppose the natural market.

Let me give you an example. I have spent time in Hawaii after the last hurricane in Hawaii. Every meeting I went to—bankers, insurance companies, realtors, builders—they all say, "You have to put a secondary market of insurance in place. Why? Because we have this $100 million apartment building, and we can't sell it because nobody is going to pick up on the mortgage unless we insure it against the risk of hurricane disaster."

I say, you know, for that individual or that corporation at risk, that is a very dangerous thing. But why are we allowing next week the next $100 million or $200 million hotel to be built in a risk area in this country?

We have identified 16 high-risk areas for disaster. We know that just as a matter of random sample, these 16 areas are going to suffer extraordinary disasters over the following years. Now, why are we forming a policy to encourage capital to improperly invest in that area by not paying for that risk? I have no objection if someone wants to put a $200- or $300-million hotel in Honolulu, as long as the taxpayers of this country and the taxpayers of my district aren't covering that investment by offering the reinsurance. Be-

cause when they do that, it is to the disadvantage of capital to flow into the areas of this country that would be lesser in risk, and would apply the opportunities and finances to benefit average Americans who will be paying for this extraordinary risk. I just think that my friends on the other side of the aisle, the people who really claim to always believe in market forces, to be advocating a program of getting the Government involved in secondary insurance is shocking to me.

I can understand that we have a problem. Maybe we have to look at how we cover that problem. There are certainly ways of doing it, including our involvement in these risk circumstances that occur on a regular basis. But why we should establish the Government involved in secondary insurance so that there will never be an incentive for a more intelligent decision of where to put your capital and encourage growth rates like Miami to continue to explode in growth, encourage areas like California to continue to explode in growth because the initial investment is being protected and insured and able to be financed with the false protection of the rest of the American people in the secondary insurance market, I think it is just a wrong proposition.

I may say, further, why aren't we looking at all disasters? Why are we only looking at hurricanes, earthquakes and tornadoes? I will tell you why. That is where the financial forces of the country are located and have risk. They are very much interested. The banking communities and everyone else that holds the paper on those things are in serious condition and asking the Federal Government, even though they are great private capitalists and entrepreneurs and want a free marketplace, but when their investment is at risk, they want the United States Government to come to them in a big way.

Let me give another example, and I know I am over my time. Mr. Chairman, we made that mistake with the nuclear power industry. This Government provided secondary insurance that limited the risk and as a result we have power stations built in this country on earthquake faults. The only reason the engineers and the owners of that capital made that investment in those areas is, after $7 or $8 billion, they had no more risk. They threw it off to the Federal Government.

Although that is more extreme now than even indicated under this legislation, the same principle applies. What we are doing is grossly interfering with the free marketplace which will affect and distort the practices of the population existing today and on into the 21st century, falsely, mistakenly, and I daresay hypocritically, if this is supported by my friends of the free market side.

When I, as a Democrat, generally find advantage for Government programs, alas, but suddenly we have interests here that want the Government to impose themselves with a major investment and a major program, I just think we haven't thought this issue out enough. I certainly don't think we've taken it to all the considerations that we should. These poor folks that are living in Idaho and Montana that aren't going to have these things, they are going to be called upon to insure these speculative investors in San Diego, in Los Angeles and in Miami. I do not think that is right. But worse than not being right, I think it is a distortion of the popu-

lation growth and how it should be distributed in this country and how the equity and wealth of this country should be distributed. Once that mistake is made, we will never put the genie back in the bottle.

Mr. LAZIO. [Presiding]. I thank the gentleman. Let me, if I can on my own time, try and correct what I think are certain misperceptions, the first of which is that there is any commercial coverage involved in either one of these versions. They are completely residential. The program is completely voluntary. It focuses on a 1-in-100-year incident, 1 percent of the risk; 99 percent of the risk continues to be in the private sector, or controlled by the States.

The reason why there are State programs is because the private sector insurance market dried up. In the months after Northridge—and Ms. Heimbuch will probably confirm this—95 percent of the private insurance homeowners insurance marketplace in that surrounding area disappeared. It creates—again, I think Ms. Heimbuch and Ms. Whatley both have testified to this point—it has created a spiraling effect, values are destroyed, people cannot sell their homes, destroying the tax base.

This is often the sole source of savings for people, certainly their largest investment. I think it certainly is not my intention and certainly is not Mr. McCollum's intention to substitute for the private marketplace. The fact is that it is not there. The reinsurance capacity is not there.

Mr. KANJORSKI. Will the Chairman yield?

Mr. LAZIO. Yes, I would be happy to yield to the gentleman.

Mr. KANJORSKI. Why isn't it there?

Mr. LAZIO. I will explain to you as has been explained to me from the experts. The reason is that companies cannot risk the ruin of having a $50- or $100-million loss per company that would wipe them out, whereas the Federal Government, because of the size, its ability to spread out the risk, is in a much better position to do that.

In our bill, in H.R. 219, we are saying, fix the actuarial rate and double it, so that you are getting more than you might if it was strictly a market rate. Hopefully, this will phaseout over a period of time. But the fact is that there is an enormous problem and there would not be a California Earthquake Agency or a Hawaiian fund if there was sufficient capacity in the private marketplace. That is why all these people have been testifying.

Mr. KANJORSKI. Mr. Chairman, would you yield?

Mr. LAZIO. Yes, I will be happy to yield to the gentleman.

Mr. KANJORSKI. Isn't that basically saying that that is why Lloyd's of London doesn't want to be a secondary insurance in these types of disasters they have experienced? Even their great resources were not enough to be secondary insurers. And isn't the argument saying that the Government has to provide a subsidy?

Mr. LAZIO. What it says, if I can reclaim my time, is that the Government has a role in providing that the market acts more efficiently.

The problem of this is that when you have a situation where you have Warren Buffet offer, whatever, I forget what the numbers were exactly, but a billion or a billion-and-a-half dollars, whatever

it was, in reinsurance, at a rate of $300-million-a-year-plus for premiums, that clearly is being done because people like Warren Buffet and a few others who won't even get into the market because they can't suffer the risk of loss have to calculate what the financial return must be in order for them to absorb a potential wipeout.

That is something the Federal Government does not have to do. So it is able, after the States have a plan in effect, after people are willing to put up their own money, people are being asked to pay premiums, it will fund—we have run, as we have heard testimony before, there have been thousands of models that have been run, and the case, if only three States participate in this plan over ten years, a $5.5 billion surplus. That may or may not happen because we can't be assured of the timing of an incident.

But the very fact is that if you walk away from a California or a Florida or a Pennsylvania, after they get hit with a major hurricane and say, "You're on your own," I cannot imagine the Federal Government will not come in as it has in the past with a major bailout, not—without having premiums paid in voluntarily because we have not been provided, we do not have the structure in place, and there is an insecurity in the marketplace and insurance companies pull out, I can't imagine the Federal Government, as a community of communities, walking away from a Florida saying, hey, tough, you know what, you have to hitch up your wagon; and you're going to have to move, Miami; you're going to have to move, Fort Lauderdale; you're going to have to move, Los Angeles.

Seventy-five percent of the population of the country is within 100 miles of the coastline. That is not going to change because of an effort at mitigation. Is mitigation important? Absolutely. But we should not delude ourselves that through mitigation we are going to change the fact of the major population centers and major infrastructure that is at risk. If we don't plan for the inevitable, we are going to be highly irresponsible in the manner in which we deal with the problem and the people that are left behind, especially those folks who have their homes as their sole source of equity.

Mr. KANJORSKI. Will the gentleman yield?

Mr. LAZIO. I will yield to the gentleman.

Mr. KANJORSKI. Mr. Chairman, that is really my point. I do appreciate, and quite frankly, I would rather the Federal Government move in to correct a disaster area and support the disaster area but not build a methodology that we are talking about building now, which will almost give carte blanche to unreasonable development and continued development in areas of the country that are at high disaster risk.

What I am suggesting is, we find some methodology to, whether up to some date insurance is available, but then communities have to restrict the growth that they have in the high exposure areas. To just turn loose a Government-subsidized secondary insuring market is to send a notice across the land that regardless to what high risk you may want to put your investment, there is going to be somebody standing there that is going to pick up that investment and you are going to take the natural controls of the free market system away, the Buffet $300-million premium isn't going to apply anymore and you are going to have the same low rate in a high disaster area as you have in a non-high disaster area. As

a result, it is going to warp the way capital is expended in this country and where population growth occurs.

Mr. LAZIO. I would say, if I can reclaim my time, this is, I think, the main bone of contention that I have with the gentleman's argument, and that is that we already have population centers in place. We are not going to move major cities. The liability or the exposure is already there. No matter what we do in terms of mitigation, we are talking about around the fringes of exposure. The $60 or $70 billion earthquake in San Francisco, the $50 billion hurricane in Florida, as a result of hitting a Miami or a Fort Lauderdale or a major population center, those population centers, that infrastructure, those homeowners, are not going to pick up and move certainly over the next ten years to an area that may be less disaster-prone. We are simply going to be in a position where we go in—I would remind the committee, I was up in North Dakota when those people, those poor folks were flooded. Those people were wiped out. Many of those families got $4-, $5-, or $6,000, which is what FEMA pays when people get wiped out.

Mr. KANJORSKI. Mr. Chairman, would you yield?

Mr. LAZIO. Yes, I would yield to the gentleman.

Mr. KANJORSKI. I am not attempting to relocate or reconstruct existing communities. I am talking about prospectively. The policy has to be of this Congress and this Nation that we can't encourage unmitigated growth because there is a Government subsidy that will support that growth. We have to find a way to allow the free market to operate. The way the reinsurance free market will operate is the premium will be so high as to discourage people from relocating to Miami. But quite frankly, Mr. Chairman, if you give me the opportunity to go to the middle of Montana, I like Montana, I should pick perhaps another State, maybe the middle of Pennsylvania so that I can prejudice my own State and build a quarter-of-a-million-dollar home or to go to Miami Beach and build a quarter-of-a-million-dollar home, normally as a citizen I look at what risk I have and what my mortgage will cost me and what my insurance will cost me.

If you create a circumstance where the Federal Government, by subsidy, creates a secondary market of insurance that doesn't cause them extreme distortion in cost—I would rather live in the nice climate of Miami—what you are going to do is continue to have compacted growth in those high-risk areas.

I am not against doing something. What I am against is doing something without realizing the long-term ramifications of what we do in the distortion of investment of capital and the location of people. I think we are talking about something now that is going to affect decades ahead of Americans.

I have worked very close because I have a disaster in my area of floods. I know how difficult it is to get people to relocate from a flood plain—damn near impossible. Quite frankly, maybe we can let the people who were there remain there, but we shouldn't encourage the population to double, triple or quadruple because people want to live in a flood plain. We have got to force or allow the private market and the free market to operate to cause the economic discouragement of exposing assets to that type of disaster or risk.

What we are doing now is not answering that question. We are solving an immediate problem and not anticipating the long-term ramifications of the solution we are offering. It will continue the distortion of growth and the pattern of growth in this country.

Mr. LAZIO. If I can reclaim my time, I know my time has probably run out. I want to at least ask one or two questions of the witnesses. I haven't had a chance to ask anyone.

Maybe Mr. Brown and Mr. Clark, both, if you would care to respond to some of the things that have been said here.

Mr. CLARK. I hesitate because I was born and raised in the 11th Congressional District in Pennsylvania, which did suffer from Hurricane Agnes; and the Federal Government did come to their rescue, thankfully, rebuilt Wilkes-Barre, part of my hometown. I agree that you have to tread carefully with Mr. Kanjorski's concerns. But also this is directed toward residential construction, so the commercial aspect is not there. It is an attempt to solve a problem. There are extraordinary numbers of homeowners without insurance in disaster-prone States.

There are an extraordinary amount of homeowners with limited and inadequate insurance and unreliable insurance. Whether we like it or not, we are going to spend money, and Mr. Kanjorski knows this better than I do, in coming to their rescue. We are not going to say no. We spent about $45 billion over the last I guess four years in emergency appropriations, supplemental appropriations above and beyond the budget. That comes out of every taxpayer's money, including the people from the 11th Congressional District. And vice versa, when something happens in the 11th District, we come to their rescue, too.

It is an extraordinary problem. I think he has got some legitimate points, but I think your bill, since it does address residential homes and not commercial, that some of those fears should be allayed—respectfully.

Mr. BROWN. I would just like to comment on that. I can understand why people want to move to sunny California or Florida and why you wouldn't want to encourage that from the standpoint of subsidizing that. But I look at my own State of Missouri. I don't think that is really going to be a problem, if we had this, that all of a sudden we are going to have a lot of people wanting to move to Kennett, all of a sudden. It would be nice, but I really think since the program is a residential type of program, we have got to take care of the people that are already there. We have got major populations in all those places.

I do understand what you are saying. We have got to do something about mitigation. We have got to teach homeowners what they can do, and everybody has a responsibility in that. I do as an insurance agent, our insurance industry, and the Congress, everybody; we do have to do more for mitigation. There is nothing I think that is sillier than paying somebody that is on the wrong side of the dam for a flood, and the same holds true for an earthquake or a hurricane. But we have to help those people make those changes and that takes time.

Mr. LAZIO. If I could, I just want to ask Ms. Heimbuch because you have had this experience through the bank, living through Northridge, the impact that it has on the financial institutions. I

wonder if you could just speak to that once again, about the implications of a major or maybe possibly two major natural disasters in your State, what that might mean for financial institutions.

Ms. HEIMBUCH. I think that you have to look at it from the point of view that, number one, with this program, we are not asking that people don't pay a premium for it. We are not asking they don't pay for this insurance. But right now they don't have much opportunity to get very much coverage. Therefore, from a financial institution's point of view, I am an insurer. I am not allowed to be in this business but I am in it for no premium. So everyone who has a loan from me who doesn't have disaster insurance after their equity is wiped out, I am the insurer, I am the one who takes the loss. I think that we saw that very clearly in the Northridge Earthquake, and for all the financial institutions in the area who had those loans.

There are certain types of properties that are more at risk, and after the earthquake, Freddie Mac tried to impose some sort of a requirement that there be disaster insurance on condominiums, or they wouldn't do the loan; and legally they weren't able to do it and marketwise they weren't able to do it. So I think from a financial institution's point of view, without some sort of program, we are at great risk because we essentially are the insurer and we are doing it for no premium.

Mr. KANJORSKI. Could I ask a question?

Mr. LAZIO. Sure.

Mr. KANJORSKI. It is interesting, because I had the experience of a disaster in my area. We went back, we tried to find out whether the banks had enforced flood insurance, and we found out that only 19 percent of those people that were actually located in the flood plain and had a disaster bothered to take flood insurance out.

What kind of enforcement are the banks going to do? Are you going to police this? Are you going to take the responsibility that you will not issue any mortgages unless the disaster insurance is taken out and the premium paid in accordance with the highest value of the property?

We can't get that in other disaster areas. I think what is going to end up is, you are going to cover your loss, and that is what you are going to enforce. So this is—I agree, this is going to be an ability for the financial institution to protect its risk. But you are not going to go out there and tell somebody, you have to take out disaster insurance in accordance with the real, true value of the property so that the fund grows and is sufficiently actuarially sound and the premiums paid. Everybody, the builders, the developers, the investors and the residents are going to make their own decision as to how much insurance they will take or can afford to take for their own self-interest.

Ultimately, you are going to have cherry-picking. Only those extremely high-risk homes, areas and disasters are going to be covered adequately to keep this fund alive or, insurance-wise, sound. It is going to fall on the responsibility of the taxpayers, anyway. Nobody in the country believes that if a disaster occurs in California that we won't go in with \$50 or \$100 or \$200 billion.

And, if I may, how can we be naive enough to think that although it starts out as a residential bill, there won't be those peo-

ple that come along and say, gee, I have 5 apartments, I have 20 apartments, I have 30 apartments, or I have a little office building, I have a medical center, I have a little hospital, and say you should cover this and that a future Congress is going to say, well, there is no private market developed, so we are going to have to start enlarging this program. Particularly, Mr. Chairman, on the other side of the aisle, you have told us for 60 years that once programs start, they grow.

Mr. LAZIO. I would just say to the gentleman that the alternative is to do nothing and to leave a place like Los Angeles completely uncovered. I think that is what, by logical extension, the gentleman's position could be argued to be.

Mr. KANJORSKI. That is the point I want to make. I think this is one of the most important issues that the country, in social planning and development, really faces. It is something that should be looked at in great depth, that whatever policy—and I believe the Government has a role in this, and I believe we should come in to start the process, but that we shouldn't do it to pervert the market effects of discouraging the bad location or the bad investment of capital or the bad investment of people.

Mr. LAZIO. Let me, if I can, I would say to the gentleman, I wish somebody were here from the California earthquake fund agency, I am sure they would say that the creation of a State program did not distort or force people to migrate in any particular area of California. As a matter of fact, it provided liquidity and it provided the assurance so that there was continued economic strength.

I will bet if we asked Ms. Whatley, which I am happy to do, from a realtor's standpoint, in an area that is disaster-prone, the failure to take action to provide after the State has already acted, after the State already has put their full faith and credit on the line for the first—in the case of Florida—$10 billion, after the private sector is already in there, people are paying premiums.

The situations—less than 1-in-100 are going to be all covered by those State programs; we are talking about situations over, in excess of a State's capacity after they have already been proactive, after they have already made plans, in excess of their capacity to deal with that and the inevitable, as we say, $50 billion "big one."

The question is, do we prepare now or do we react to that when the inevitable happens by making a political statement and rushing something through without the type of safeguards that I think we have in the bill and we will add to the bill before it is completely enacted?

Mr. KANJORSKI. Mr. Chairman, I just can't believe that you are going to really see an honest growth of a reinsurance or secondary market. I think the insurance people and Lloyd's of London are awfully wise people. I certainly have a great deal of respect for Mr. Buffet. I think to even have the secondary insurance market start in disaster areas is going to be extremely difficult.

Mr. LAZIO. It is already there.

Mr. KANJORSKI. But if we provide a subsidized program and get it started, I don't see it ever growing.

Mr. LAZIO. I say to the gentleman, it is already there, if I can reclaim my time.

In California, for example, they buy reinsurance as part of their fund. There is securitization in Florida and in California, I believe. The capital markets are trying to grow. As a matter of fact, one of the major discussions here is to ensure that the capital markets and the reinsurance industry continue to grow into the demand that exists.

I am all for that. But certainly as we have heard in testimony all day long, the capacity is not there in the private sector right now to permit insurance companies to write policies for homeowners'—I underline "homeowners'"—in these areas without the confidence of knowing that they have these programs standing behind them. It just doesn't exist.

And the alternative—again, I relate back to the Northridge; I think it is a recent and stark contrast to the concept of sort of doing nothing—95 percent of the companies stopped writing in the area.

Mr. KANJORSKI. Mr. Chairman, if I can just say, what is going to stop the expansion of areas like La Jolla, California, and others that would be exposed to this disaster from doubling, tripling, quadrupling over the next 10, 20, or 30 years if we provide a subsidized system that allows for that insurance to take care of that disaster? It is not an easy question.

But I am saying when you are taking off the free market premium cost, you are cutting loose for people to relocate to and develop an industry to locate to disaster areas because there is going to be a way of having people build homes that are already in impacted areas with high exposure and high disaster costs if disaster occurs. As I said, 30 years from now, when a storm like Andrew moves into the Miami area 20 miles north of where it came in, you are going to have $150 billion exposure. The reason is that Miami is going to triple in size. We have no way, if we don't use the free market forces, to discourage that from happening.

Mr. LAZIO. I understand the gentleman's point.

Let me thank the panelists for your patience. It has been a very long day. I appreciate the testimony. All the written testimony will be included in the record.

Again, have a safe ride home wherever that might be. This hearing is in adjournment.

[Whereupon, at 6:20 p.m., the hearing was adjourned.]

APPENDIX

April 23, 1998

CURRENCY

The Committee on Banking and Financial Services
U.S House of Representatives, 105th Congress
James A. Leach, Chairman

Phone: (202) 226-0471 Fax: (202) 226-6052 Internet: http://www.house.gov/banking

For Immediate Release
Thursday, April 23, 1998

Contact: David Runkel or
Andrew Biggs 226-0471

Opening Statement
Of Chairman James A. Leach
Committee on Banking and Financial Services
H.R. 219—Homeowners Insurance Availability Act Hearing

The Committee meets today to hear testimony on H.R. 219—the Homeowners Insurance Availability Act of 1997, which was introduced by Housing Subcommittee Chairman Rick Lazio. The Housing Subcommittee reported the bill on February 4, 1998 with bipartisan support.

This legislation, along with that of a similar proposal of Committee Vice-Chairman Bill McCollum, highlights a growing problem in some states where homeowners insurance has become difficult, if not impossible to obtain, at affordable rates.

For example, after the 1994 Northridge Earthquake in California, 95% of the homeowners' insurance market shut down. In 1992, Hurricane Andrew cleanup in Southeast Florida cost $33 billion and, according to the Florida Department of Insurance, "created an environment where massive cancellations of homeowners polices and retreat from the state by insurance companies were at hand."

Moreover, a 1996 study indicated that the number of insurance underwriters dropped, within the last 10 years, by 31% in Florida, 29% in Texas, 23% in California and 15% in Pennsylvania. These conditions precipitated the creation of state insurance programs to meet the gap between homeowners and participating insurers. Despite withdrawals from the insurance market, the property-casualty industry has nearly doubled its capital and surplus since 1992 and experienced record profits in 1997.

While there may be competing philosophical views regarding the nature and role of the federal government, all parties would agree that the problem of insurance availability in disaster prone areas is real and is worthy of congressional attention.

Traditionally, the issue of natural disaster assistance has been under the purview of another Committee that primarily focused on the Stafford Disaster Assistance Act and mitigation of natural hazards through building and zoning code enforcement, as well as federal incentives to expand capital in the reinsurance capital markets.

The Banking Committee's interest centers on the fundamental question of whether there is an

appropriate federal role in the intervention of capital markets to ensure affordable homeowners insurance, while at the same time meeting actuarial standards that avoid federal contingent liabilities.

The Housing Subcommittee held two hearings on this issue and Mr. Lazio, Mr. McCollum and I have had many conversations with both Secretary Rubin and Deputy Secretary Summers, who have committed to working with the Committee in perfecting the legislation before we move to a full Committee markup.

In addition to Mr. Summers, a broad spectrum of witnesses representing every sector and voice interested in this legislation will be before us today. I am hopeful that following this hearing, the Committee will produce a bill that ensures an open market for homeowners insurance, while at the same time protecting the Federal government from financial exposure. The Subcommittee's bill appears to be a viable foundation for full Committee consideration.

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Congressman Maurice D. Hinchey
Opening Statement
Hearing on the Homeowners Insurance Availability Act
House Banking & Financial Services Committee
April 23, 1998

Mr. Chairman, thank you for calling this hearing to look into the issue of the availability and affordability of homeowner's insurance in disaster-prone areas. As you know, the Housing and Community Opportunity Subcommittee marked up H.R. 219, the *Homeowners' Insurance Availability Act* in February. At that time, many members, including myself, had grave concerns about this legislation that we did not feel were adequately addressed. I commend you Mr. Chairman, for attempting to answer some of these questions in this hearing today.

At the outset, I remain skeptical about a scheme of federal reinsurance, particularly one that would require states to establish funds or pool or auctions before they were able to participate. My own state of New York recently rejected this idea after many months of careful study. A special panel appointed by the state legislature found that establishment of a natural disaster fund would "disrupt the New York homeowners' insurance market and significantly increase the cost of insurance." In addition, they found that recent improvements in the homeowners' insurance market and the private reinsurance market make a state fund unnecessary.

Homeowners in my District and elsewhere who are not exposed to great hurricane risk – which I might add is most of the state – would end up subsidizing those who live in coastal areas. The plan under consideration in New York would have been funded in part by a statewide 2- to 4-percent emergency assessment on all property-casualty insurers. Thus, consumers of auto, commercial, farm, surety, and other forms of property and casualty insurance throughout the state would have borne the burden of hurricane losses.

In addition, the Panel noted that the capacity of the private reinsurance market in New York has expanded in recent years to cover the losses from catastrophic disasters. In the last seven years, the industry's surplus has increased 75 percent to $280 billion. The cost of reinsurance is back to pre-Hurricane Andrew days, and availability is not a problem. In addition, the securities industry has been developing products to securitize catastrophe risk. Furthermore, the Panel did not find that a catastrophic insurance fund would do anything to improve insurance availability.

Mr. Chairman, before we obligate the federal government for huge losses, we must make sure that any program we create does not give companies and states the incentives to price disaster insurance too low in the expectation of a federal bailout. Rather, we should give careful consideration to the experience of states like New York that have rejected the notion of a catastrophic disaster insurance fund in favor of private market solutions.

Again, Mr. Chairman, thank you for calling this hearing today. I look forward to the testimony of the witnesses.

REPRESENTATIVE DARLENE HOOLEY
STATEMENT ON H.R. 219
COMMITTEE ON BANKING AND FINANCIAL SERVICES
APRIL 23, 1998

Thank you Mr. Chairman. I would like to begin by stating my strong support for passing federal legislation to increase the availability of homeowners insurance in the United States. I represent an area in Oregon that is prone to natural disasters and certainly have a great interest in passing a bill that would increase the accessability and affordability of homeowners' insurance.

Protecting homeowners from natural disasters is clearly a goal that every member of the subcommittee, and this Congress, shares. However, while there is some bipartisan agreement on the need for a federal role, there is not widespread agreement on what is the best way this objective can be met.

In my view, there are two key components that must be part of any federal plan to increase the availability of homeowners' insurance. The first of these is a reasonable certainty that the plan will actually increase the availability and affordability of insurance for consumers. Secondly, any federal program must be structured to ensure that the resources of the private market are exhausted before turning to a federal backstop. In other words, I want to stress that while I support a federal role, that role must be to back up the private sector in areas where it is clear private sector resources are not sufficient. The federal government should be instilling confidence in, not competing with the private market to provide homeowners insurance.

As a Member of Congress who represents a district prone to natural disasters, I very much appreciate the Chairman's commitment to this issue and efforts in developing this legislation. As I noted during the markup on this legislation, my state, among others in the Northwest, lies in an active volcanic zone and is realistically susceptible to a volcanic disaster of significant proportions.

I appreciate the willingness of the Chairman to work with me to resolve problems in my state regarding these types of perils. I am aware that staff have been working on a reasonable solution and I am hopeful that the Committee will decide to include coverage for volcano disasters in the final version of this legislation. I look forward to continuing this conversation as we move closer to markup.

Today, I am anxious to proceed with a thorough examination of this legislation. While I have cautiously supported this legislation to this point, I intend to keep an open mind as we continue working for a bill that is truly beneficial for Oregonians and all citizens who live in disaster prone areas.

Thank you Mr. Chairman.

A

SPECIAL REPORT
(Pursuant to Chapter 66 of the Laws Of 1997)

TO

GOVERNOR PATAKI
AND
THE NEW YORK STATE LEGISLATURE

ON

A STUDY OF MARKET DYNAMICS AND
HOMEOWNERS INSURANCE POLICIES
WRITTEN, CANCELED, OR NONRENEWED
IN DESIGNATED GEOGRAPHIC AREAS

FEBRUARY 15, 1998

NEW YORK STATE INSURANCE DEPARTMENT
NEIL D. LEVIN
SUPERINTENDENT OF INSURANCE

STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

To the Governor and the Legislature:

This "Special Report on a Study of Market Dynamics and Homeowners Insurance Policies Written, Canceled or Nonrenewed in Designated Geographic Areas" is herewith presented, in accordance with the requirements of Chapter 66 of the Laws of 1997.

Respectfully submitted,

NEIL D. LEVIN
SUPERINTENDENT OF INSURANCE

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EXECUTIVE SUMMARY AND RECOMMENDATIONS

Chapter 66 of the Laws of 1997 amended subsection (2)(E) of Section 3425(o) of the Insurance Law to require the Superintendent of Insurance to conduct a study of market dynamics and homeowners insurance policies written, canceled or nonrenewed in designated geographic areas, and report to the Governor and the Legislature thereon, on or before February 15, 1998.

In response to the problems facing individual property owners, the Legislature and the Department initiated several actions which appear to have brought some stability to this market. Statutory changes enacted in the past few years provide for: multi-tier rating programs; compulsory reporting for plans of withdrawal from the homeowners insurance marketplace; and the authorization of the New York Property Insurance Underwriting Association (NYPIUA) to write homeowners insurance upon a determination of necessity by the Superintendent. Department initiatives include: the opening of a permanent satellite office on Long Island to assist consumers in the area with insurance problems; the creation of a special hotline for updated availability information on homeowners insurance; the coordination of the Coastal Market Assistance Program (CMAP) with insurers to either place or keep insureds in the voluntary market when they are having difficulty placing or renewing their homeowners insurance; and the monitoring of data submitted by insurers on a quarterly basis.

The Department's February 15, 1997 report, "A Study of Market Dynamics of Homeowners Insurance Policies Written, Canceled, or Nonrenewed in Designated Geographic Areas", described the development of the homeowners marketplace and the causes of changes in it; introduced and analyzed statistics maintained by the Department and NYPIUA; and discussed the recommendations that were published by the Temporary Panel on Homeowners' Insurance Coverage in its October 1, 1996 report. This report updates all statistics; reports on the current status of the various legislative and regulatory initiatives; and comments on the recommendations made by the Temporary Panel on Homeowners' Insurance Coverage in its most recent report.

Our findings and recommendations include the following:

- Homeowners insurance remains readily available to the vast majority of residents throughout the State. Owners of dwellings located closest to the shore continue to experience some difficulties in obtaining insurance. Historically, owners of such properties have had to contend with underwriters' reluctance to assume risk in these areas.

- The most recent data compiled from industry reports provide indications of a gradually mitigating trend in assuming risk in these areas. Voluntary market writings appear to

have stabilized and modestly increased, and the number of new policies written in the residual market as reflected in NYPIUA's statistics appears to have peaked.

- NYPIUA's legislative authority should be made permanent in order for it to be able to borrow funds in the event of a catastrophe. However, it should not be required to provide large windstorm deductibles on a mandatory basis.

- The Department cannot consider the use of computer modeling as a standard actuarial technique for the development of homeowners insurance rates until all the components of a model are routinely available for review.

- Measures taken in response to the lack of availability of insurance in these areas, along with the Department's monitoring of market conditions and the continued cooperation of the industry, appear to have contributed to modest improvements. However, the current problems developed over many years and were the result of many complex factors. It would be unrealistic to believe that those problems will be entirely solved in a short period.

A STUDY OF THE MARKET DYNAMICS AND HOMEOWNERS INSURANCE POLICIES WRITTEN, CANCELED, OR NONRENEWED IN DESIGNATED GEOGRAPHIC AREAS

PURPOSE

This report is submitted pursuant to Section 1 of Chapter 66 of the Laws of 1997, which directed the Superintendent to conduct a study of the market dynamics and homeowners insurance policies written, canceled, and nonrenewed in designated geographical regions of the State, and to report his findings to the Legislature by February 15, 1998.

Accordingly, for the purposes of this report, the Department took into account the geographical areas designated in Section 3425(o)(2)(B) that indicate that the Superintendent shall assess the impact of market dynamics in the counties of Nassau and Suffolk; and those geographic areas within one mile of a saltwater shoreline, canal or bay in the counties of Queens, Kings (Brooklyn), Richmond (Staten Island), Bronx and Westchester. In addition, this report examines the impact of market dynamics in those areas in which the Superintendent has found that writings by the New York Property Insurance Underwriting Association ("NYPIUA") have increased significantly since January 1, 1992.

OVERVIEW

In recent years, catastrophic weather phenomena, such as hurricanes, floods, windstorms and earthquakes have had a dramatic impact on the lives and fortunes of individual property owners and, in turn, on the homeowners' insurance market. More and more attention has been focused on weather conditions affecting various regions of the United States and the rest of the world, along with attempts to explain their causes and develop ways to mitigate the impact of future disasters. "El Nino" forecasts have become a staple item on local and national news broadcasts, and much attention has been focused on the construction of dams and levees, the geographical placement of new housing developments, and the upgrading of housing construction guidelines.

These concerns have had an effect on the availability and affordability of homeowners insurance in New York. Although the homeowners insurance market, which developed along with the growth of the nation's suburbs after World War II, has consistently been profitable in this State, insurers have reevaluated their market strategies and positions, particularly in the State's coastal areas. These and other factors that have influenced insurers' actions were discussed in detail in the Department's previous report, "A Study of Market Dynamics of Homeowners Insurance Policies Written, Canceled, or Nonrenewed in Designated Geographic Areas", which was submitted on February 15, 1997, pursuant to Chapter 42 of the Laws of 1996.

In response to the problems facing individual property owners, the Legislature and the Department initiated several actions which appear to have brought some stability to this market. Statutory changes enacted in the past few years provide for: multi-tier rating programs; compulsory reporting for plans of withdrawal from the homeowners insurance marketplace; and the authorization of the New York Property Insurance Underwriting Association (NYPIUA) to write homeowners insurance upon a determination of necessity by the Superintendent. Department initiatives include: the opening of a permanent satellite office on Long Island to assist consumers in the area with insurance problems; the creation of a special hotline for updated availability information on homeowners insurance; the coordination of the Coastal Market Assistance Program (CMAP) with insurers and NYPIUA to provide individuals with coverage when they are having difficulty placing or renewing their homeowners insurance; and the monitoring of data submitted by insurers on a quarterly basis.

The Department's February 15, 1997 Report described the development of the homeowners marketplace and causes of changes in it; introduced and analyzed statistics maintained by the Department and NYPIUA; and discussed the recommendations that were published by the Temporary Panel on Homeowners' Insurance Coverage in its October 1, 1996 report. This report will update all statistics; report on the current status of the various legislative and regulatory initiatives; and comment on the recommendations made by the Temporary Panel on Homeowners' Insurance Coverage in its most recent report.

CURRENT STATUS OF POLICIES IN THE MARKETPLACE

Insurance Department's Collection of Regulation 154 Data

Legislative mandates require the Department to study the dynamics of the homeowners insurance marketplace. In fulfilling this obligation, the Department promulgated Regulation No. 154 (11 NYCRR 19), which, among its provisions, requires insurers writing homeowners insurance in the voluntary marketplace to report, on a quarterly basis: the number of policies in force; new policies written; terminated policies (either by the insured or the insurer); transfers of business; and the number of producers authorized to transact business on behalf of the insurer. This information was collected for all counties in New York State and for designated zip code areas. The Department's 1997 report exhibited data collected as of September 30, 1996. This report will exhibit data collected from September 30, 1996, through September 30, 1997. Because of the time frames for filing this information, data as of December 31, 1997, are not yet available for analysis.

The data in Illustration 1 below show policy-in-force figures for designated coastal areas. In comparing the beginning and end policies-in-force, it is noted that there has been an overall increase of approximately 6.6% in writings in the voluntary market.

New York Property Insurance Underwriting Association

Illustration 3 shows NYPIUA's residential policies-in-force for the designated coastal areas. These figures continue the trend exhibited in previous years, which is that of an increase in NYPIUA's writings in downstate areas. However, applications for new business declined in 1997, which indicates that NYPIUA's writings may have peaked and are now in a downward trend.

Illustration 3

NEW YORK PROPERTY INSURANCE UNDERWRITING ASSOCIATION
POLICIES IN FORCE

	12/31/94	12/31/95	12/31/96	12/31/97	Percentage Change 1996-1997
Bronx	2,981	3,165	3,439	3,579	4.07%
Kings	15,400	16,128	17,210	17,721	2.97%
Queens	5,163	6,635	8,698	9,885	13.65%
Richmond	761	1,064	1,440	1,674	16.25%
Westchester	442	534	651	711	9.22%
Nassau	1,528	2,597	4,282	5,333	24.54%
Suffolk	5,360	7,152	9,477	10,953	15.57%
Total for Selected Counties	**31,635**	**37,275**	**45,197**	**49,856**	**10.31%**

Additionally, the data shown below in Illustration 4 indicate that although NYPIUA's writings have increased, it appears to be due to a constant influx of new business rather than insureds who remain with NYPIUA for an extended period of time. In-force policy figures are the total of new policies and renewal policies in force at any given time. In NYPIUA's case, while the total in-force figure for each year has increased, the year-end total policies-in-force in each territory compared to the renewal policies in the following year in that same territory indicates that many NYPIUA policyholders are leaving NYPIUA each year and presumably finding coverage in the voluntary market.

Illustration 4

TRENDS IN DOWNSTATE WRITINGS BY NYPIUA

	12/31/95	12/31/96	12/31/97
KINGS			
New	2,857	3,362	2,870
Renewal	13,271	13,848	14,851
Total	16,128	17,210	17,721
BRONX			
New	644	777	699
Renewal	2,521	2,662	2,880
Total	3,165	3,439	3,579
NASSAU			
New	1,431	2,195	1,840
Renewal	1,166	2,087	3,493
Total	2,597	4,282	5,333
QUEENS			
New	2,571	3,384	2,847
Renewal	4,064	5,314	7,038
Total	6,635	8,698	9,885
RICHMOND			
New	534	636	541
Renewal	530	804	1,133
Total	1,064	1,440	1,674
SUFFOLK			
New	2,376	3,159	2,804
Renewal	4,776	6,318	8,149
Total	7,152	9,477	10,953
WESTCHESTER			
New	195	244	209
Renewal	339	407	502
Total	534	651	711
TOTAL			
New	10,608	13,757	11,810
Renewal	26,667	31,440	38,046
Total	37,275	45,197	49,856

For example, in Nassau County there were 2,597 policies in force at the end of 1995. By the end of 1996, only 2,087 of those policies were renewed, indicating that 510 insureds had, presumably, found coverage elsewhere. During 1996, NYPIUA wrote 2,195 new policies to reach a total in force count of 4,282 at the end of 1996, resulting in an overall increase of 1,685 from the previous year. This example holds true for every year in every county. It may be that after an insured has been with NYPIUA for a period of time and established a viable insurance history, that risk becomes more attractive to writers in the voluntary market and is able to obtain coverage there.

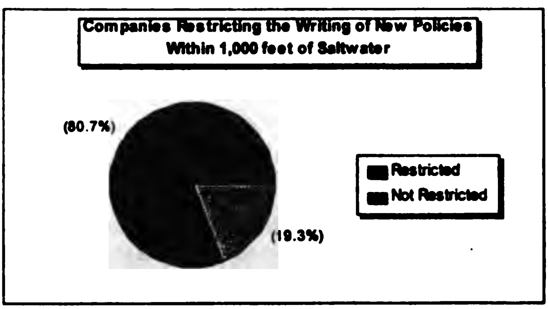
Information on NYPIUA's residential policies-in-force for the entire state for the period December 31, 1990 through December 31, 1997, is presented in Appendix D.

Underwriting Restrictions in Coastal Areas

Illustrations 5 and 6 indicate the percentage of companies that had restricted coverage in areas within 1,000 feet of saltwater. This information is shown on a percentage basis as it relates to the number of companies in the homeowners market that have underwriting restrictions, and to the corresponding percentage of premiums written during 1996.

Illustration 5

Percentage of Reporting Companies Restricting Coverage in Areas Within 1,000 feet of Saltwater



Note: All figures based on credible data received from companies representing 93.53% of the state wide 1996 homeowners insurance market.

The reporting companies described as "Restricted" and "Not Restricted" in illustration 6 are companies currently writing new policies on Long Island, while the "Premium" and "Percentage of 1996 Homeowners Premium" figures reflect their statewide direct written premiums.

Illustration 6

Restriction on Policies within 1000 feet of Saltwater	Premium	Number of Companies	Percentage of 1996 Homeowners Premium
Restricted	$1,542,834,846	92	75.52%
Not Restricted	367,890,134	23	18.01%
Total Reporting	1,910,724,980	115	93.53%
Total All Companies	2,042,838,395	207	

Note: All figures based on credible data received from companies representing 93.53% of the state wide 1996 homeowners insurance market.

Other Data

Prior to the current legislative mandate, the Department had been collecting policy-in-force data since 1992 from individual insurers representing 95% of the homeowners market. The data are shown in Appendices E and F for all of New York State, and Long Island, respectively, as of January 1 of each year. Since 1992, there has been an increase of approximately 320,800 policies statewide, with 38,144 of those policies being written on Long Island. The data also indicates that while some insurers have substantially reduced their writings, other insurers have either steadily increased their market share or have newly entered this market. The figures from this survey are generally higher than those collected pursuant to Regulation 154 since this survey does not have the filing exemption for those insurers who write less than $500,000 in homeowners premiums per calendar year.

RESPONSES TO THE COASTAL AVAILABILITY PROBLEM

The Department has taken several initiatives to assist New York State residents, located near the shore or waterfront areas, who have experienced difficulty in purchasing or maintaining their homeowners insurance. A brief explanation of each initiative is provided below along with an update of activity occurring since the previous report was issued.

C-MART

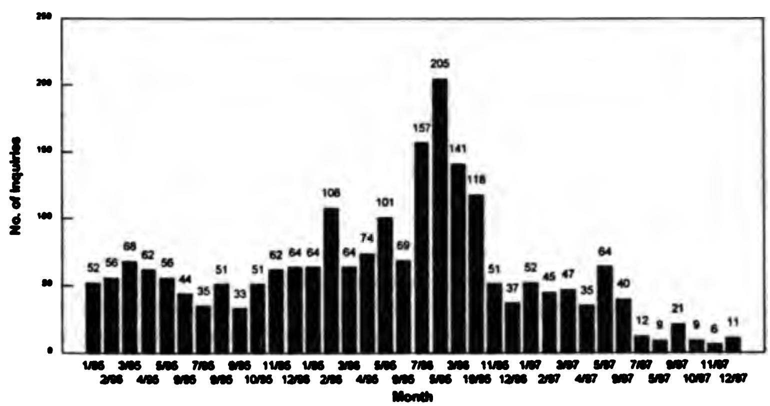
Coastal Market Assistance Reference Tables (C-MART) were established containing up-to-date names and telephone numbers of insurance companies which had advised the Department that they would insure risks within a certain proximity of the shore. This information has been available to consumers through the Department's personal lines telephone hotline.

Monitoring of C-MART activity indicated that during 1995, 634 inquiries were received; in 1996, 1189 inquiries were received; and in 1997, 351 were received. The data broken down by county indicate that Nassau and Suffolk Counties generated just over 70% of all calls. The predominant reasons for the calls were (1) policy nonrenewed after 3-year required period - 51.6%; (2) unable to secure insurance - 27.8%; and (3) cancellation during first 60 days policy was in effect - 8%. The remaining calls dealt with difficulty in settling claims or requests for insurer availability information. The callers were duly referred to the insurers on the list.

The trend in consumer inquiries is presented in Illustration 7 below.

Illustration 7

Consumer Inquiries
1995-1997



CMAP

The Department established the Coastal Market Assistance Program (CMAP) in March of 1996. This is a voluntary network of insurers and insurance producers that assist New York homeowners in coastal areas in obtaining insurance. The program was established for owner-occupied, one-to-four family dwellings, including condominiums and cooperative apartments, in the Bronx, Brooklyn, Nassau, Queens, Staten Island, Suffolk and Westchester. On Long Island's north and south shores , as well as in Brooklyn, Queens and Staten Island, the dwelling must be located within one mile of the shore. On the north shore of Long Island and in the Bronx and Westchester, the home must be within 2,500 feet of the shore to qualify for consideration.

Before applying to CMAP, a homeowner must have been notified that an existing policy is being canceled or nonrenewed for other than nonpayment of premium. In the case of the sale of real estate, the homeowner or prospective property owner must be unable to find insurance through the voluntary market. Insureds may apply to CMAP through their insurance agent or broker or by contacting the Department for further information.

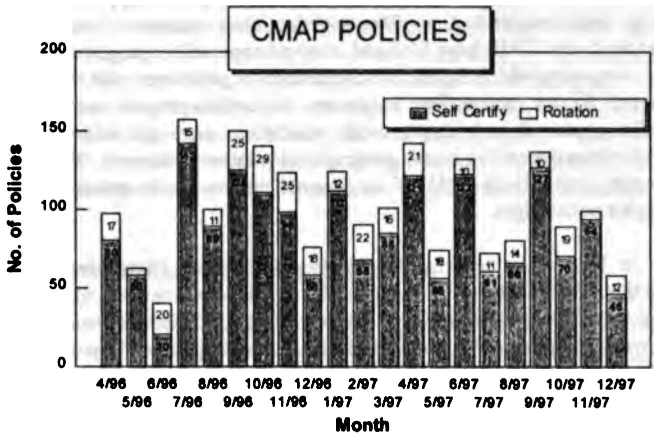
CMAP participation consists of insurers which collectively write over 80% of the homeowners market in New York. The total commitment of CMAP participants is 5,000 policies over a three-year period.

Policies may be placed in the CMAP program through either the company/agent rotation process or the self-certification process. In the company/agent rotation process, an insured will be reviewed for coverage by a participating insurer, according to the CMAP Plan of Operations, who has been assigned this risk on a rotating basis. Insurers may also use the self-certification process by voluntarily accepting a risk which does not meet their "proximity to shore" underwriting guidelines and which was not brought to them through CMAP. Once the insurer has filed the appropriate self-certification documentation with the CMAP program regarding its voluntary acceptance of this risk, the insurer will receive a credit in the CMAP rotation process.

From the inception of this program on March 18, 1996, through December of 1997, a total of 2,143 policies have been written. Of this total, 334 were placed through the company/agent rotation process, while 1,809 policies were placed in CMAP through the self-certification process. In addition, as evidenced in Illustration 8, activity in CMAP increased substantially with the July, 1996 opening of the Department's satellite office in Seaford, Long Island, and overall demand has been consistent since that time. The closing of the Seaford office and the opening of the Department's permanent office in Mineola, Long Island, in October, 1997, does not seem to have had any impact on insureds' utilization of this service.

Illustration 8

The Placement of CMAP Policies by Rotation or Self-Certification
1996-1997



NYPIUA

Chapter 66 of the Laws of 1997 extended various provisions of the Insurance Law that authorize the activities of NYPIUA through April 30, 1998. These provisions include the authority of NYPIUA to write homeowners insurance policies upon a determination of necessity made by the Superintendent of Insurance. The Department believes that its initiatives, along with the industry's cooperation, have resolved many of the problems existing in the homeowners market. However, the activation of NYPIUA to write homeowners insurance remains a possibility should the situation deteriorate.

Windstorm Deductibles

The Department encouraged the use of windstorm deductible programs as a means of encouraging insurers' involvement in the voluntary market. Deductibles offer an alternative to nonrenewals or reduction of homeowners business, particularly in vulnerable geographic areas such as Long Island and other coastal areas. Following a series of meetings with concerned public officials, consumers, producers, and insurers, the Department issued Circular Letter No. 11 in September of 1993 (which was supplemented

in October, 1993, and June, 1995) to set forth guidelines for mandatory and optional windstorm deductibles for catastrophic and non-catastrophic losses. The Circular Letter also permitted insurers to file independent windstorm deductible programs which were supported with adequate justification.

Currently, twenty-three insurers have received approval from the Department for their independent windstorm deductible programs. Two rate service organizations (AAIS and URB) have filed and received approval for programs on behalf of their member companies which follow the Department's guidelines. ISO has filed and received approval for an independent windstorm deductible program on behalf of its members. The approved programs provide windstorm coverage subject to certain mandatory deductibles depending on the geographical location of the risk. The mandatory deductibles range from 1% to 7.5% of the insured amount, with optional deductibles available at higher percentages.

In both of its reports, the Temporary Panel on Homeowners Insurance recommended that NYPIUA be given the authority to use hurricane deductibles similar to any which are approved for the voluntary market. NYPIUA submitted such a filing in 1997, but it was disapproved by the Department. The Department's position on this subject is discussed herein in our comments on the Panel's recommendations.

In addition, there has been some discussion with respect to mandating hurricane deductibles for all homeowners insurance policies. (The report of the 1996 Temporary Panel included such a recommendation.) The Department's approval of deductible programs has been determined by the experience and market needs of individual insurers, based upon data furnished in specific filings by those insurers. Mandatory programs imposed on all insurers are not needed to improve the homeowners insurance market overall, and could result in reduction of necessary coverage where conditions do not warrant such reduction.

Wrap-around Policies

In Circular Letter 11 (1993), the Department established guidelines for the submission of "wrap-around" coverage filings. Under these programs, an insurer provides liability, theft and other coverages to an insured who has purchased fire and extended coverage through NYPIUA. With the fire coverage from NYPIUA and the wrap-around coverages from a voluntary insurer, an insured can obtain the virtual equivalent of a full homeowners policy. Since 1994, the Department has approved 25 wrap-around programs, including one for a rate service organization.

Multi-tier Programs

Chapter 42 of the Laws of 1996 added Section 2351 to the Insurance Law to permit the use of multi-tier programs for homeowners insurance in order to enhance the

availability of homeowners insurance in the voluntary market. A multi-tier program is one in which there is more than one rate level, or tier, in the same company, with a complete rating system associated with each tier. Specific underwriting rules applicable to each tier determine the placement of insureds in the various rating tiers.

Multi-tier legislation for homeowners insurance formalized the rating options that had previously been available to (and were implemented by) insurers in affiliated fleet structures. Many such groups employed diverse underwriting criteria and rate levels that were exclusive to individual companies within the group. Approval had also been granted to independent insurers which were able to satisfactorily demonstrate that specially established preferred rate classifications would be objectively applied in accordance with the principles of the open rating law. As a result, there has not been a great number of new proposals filed for multi-tier programs under the new law.

Plans of Orderly Withdrawal From a Market

Chapter 42 of the Laws of 1996 amended Section 3425(o) of the Insurance Law to require insurers that intend to materially reduce their volume of homeowners policy writings to submit to the Department a plan of orderly reduction of such policies at least 60 days in advance of implementation. The Superintendent has thirty days to either approve or disapprove the plan. If the insurer demonstrates that the material reduction of policies will be accomplished in a manner that minimizes market disruption, the plan must be approved. If it does not satisfactorily indicate that the plan will accomplish this, the plan must be disapproved and the insurer will be advised of the plan's deficiencies and any amendments that the Superintendent may require consistent with the statute.

According to the statute, a plan must be submitted if the insurer intends to reduce the net number of its homeowners policies by : (a) 20% or 500 policies, whichever is greater, over a five year period, or (b) 4% or 100 policies, whichever is greater, over a twelve month period.

The statute also required the Superintendent to issue a regulation to establish standards by which these plans would be approved and to define the term "minimizes market disruption." Accordingly, Regulation 154, "Homeowners Insurance; Application for Withdrawal from the Marketplace", was promulgated on June 25, 1996. This regulation established the standards and definitions to be used by insurers submitting plans of market withdrawal and established the requirement for quarterly reporting of homeowners policy data to the Department. Circular Letter No. 10 (1996) set forth the standards to be followed in completing the quarterly reports, and also defined the designated geographical areas in which policies issued by NYPIUA have increased significantly.

To date, four plans of homeowners market withdrawal affecting approximately 7,800 insureds have been placed in effect. The vast majority of these insureds were offered renewals by carriers in the voluntary market.

OTHER INITIATIVES

Reinsurance Costs

In February, 1996, the Department began to permit insurers to reflect the cost of catastrophe excess-of-loss reinsurance in homeowners insurance rate filings, provided an insurer can reasonably allocate the cost of such reinsurance to its New York policyholders. Since that time, fourteen insurers have submitted seventeen filings which contain factors for reinsurance costs. Twelve of those filings have been accepted and five are still under review. During 1997, the Department accepted five homeowners rate filings in which reinsurance costs were among the factors in the rate increase. The state-wide rate effect of those filings ranged from -5% to +10.9%. These rate level changes fall within the ranges acknowledged for all homeowners rate filings during 1997. (In the past year, twenty-six independent rate filings, which did not include reinsurance costs as a factor, were placed on file with state-wide rate effects of -4% to +18%.)

The Department has recently begun reviewing the reinsurance contracts of insurers that used reinsurance costs as a factor in previous rate increases. This was initiated to determine that consideration is also given to reductions in reinsurance costs in insurers' preparations of rate revisions.

Long Island Office

In order to provide quicker access to the various programs that were designed to assist Long Island residents in resolving problems associated with homeowners insurance, the Department opened a satellite office in Seaford, New York, in July of 1996. Due to the need for these and other insurance services, the Seaford office's functions were transferred to a new permanent office in Mineola, New York, in October of 1997. Staffed by Insurance Department examiners and fraud investigators, this office provides vital information and assistance to members of the public who reside on Long Island.

Market Conduct Activities

The Department performed market conduct investigations of eleven insurers to determine the status of the homeowners market in the downstate coastal area of New York. The goal of these reviews was to gain a clear picture of how insurers are treating coastal homeowners business from three different perspectives: claims handling, underwriting judgment, and agency terminations. The companies investigated were the Kemper Group; the Hartford Group; Worcester Insurance Company; Tri-State Insurance Company; Preferred Mutual Insurance Company; Prudential Property & Casualty

Insurance Company; Allstate Insurance Company; Nationwide Insurance Company; Metropolitan Property & Casualty Insurance Company; Aetna Casualty & Surety Company; and State Farm Insurance Company.

Overall, the investigations did not find evidence of unfavorable claims handling practices by companies insuring policyholders residing in downstate coastal areas, in comparison to the remainder of the State.

The review of underwriting guidelines and practices indicates that companies do have more stringent controls in place for writing coverage in coastal Long Island. In particular, companies have been using the results of credit reports as a reason to decline to issue homeowners insurance to individuals. While this practice does not violate any insurance law or regulation, companies using this underwriting practice were declining coverage based on "adverse credit report" or "unacceptable financial stability". Insurers were advised of the Department's General Counsel's opinion that Section 3425 requires a specific reason for declination and that the reasons being used were not considered specific enough. All companies notified of this agreed to modify their procedures and list the specific reason on their declination notices.

The review of terminated and active agents indicated no evidence of companies terminating downstate agencies in an attempt to reduce their writings.

THE TEMPORARY PANEL ON HOMEOWNERS INSURANCE COVERAGE

Section 4 of Chapter 66 of the Laws of 1997, directed the special advisory panel established pursuant to Section 12 of Chapter 42 of the Laws of 1996 to make an additional report to the Governor and Legislature on the problems affecting the availability and affordability of homeowners insurance in New York State. The Temporary Panel was comprised of thirteen members appointed by Governor Pataki and various members of the New York State Legislature. Although the report was prepared pursuant to meetings conducted in the New York Insurance Department's offices, and the report was published by the Department, the report is not an official publication of the New York State Insurance Department. It is the findings and opinions of the thirteen appointed members of the Temporary Panel, and not those of the Insurance Department. The Panel's most recent report included several recommendations relevant to the Department's activity on this subject. Following are our observations and comments on selected recommendations.

- *The Insurance Department should consider the use of computer modeling as an acceptable actuarial technique for the development of both rates and deductibles.*

For several years, the Department has been reviewing rate filings containing factors related to catastrophe models. The models have been separated from the actual loss and expense data and analyzed in order to assess their validity as a tool in calculating

indicated rate level changes. Although insurers have furnished the Department with information at their disposal, the underlying data, assumptions, and key components of modeling methodologies used have been retained by the modelers because of proprietary concerns. Since there is no guarantee that the data will not be accessed by others under New York's Freedom of Information Law, the modelers have declined to permit the release of some data that is crucial to a thorough review of a model's validity.

The lack of complete information underlying a rate filing makes it impossible for the Department to determine with any degree of certainty that the rates produced using the model are not -- as required by statute -- excessive, inadequate, unfairly discriminatory, destructive of competition or detrimental to the solvency of insurers. Therefore, while Department actuaries have met with several modelers on a number of occasions and continue to research and study the facts, figures and assumptions surrounding this issue, the Department cannot at this time develop a position on the validity of catastrophe modeling that can be applied uniformly to all rate filings.

- *Efforts to improve consumers' understanding of the nature and effects of hurricane deductibles should be promoted.*

The Department concurs that there should be proper disclosure to make policyholders aware that they become responsible for a greater portion of a loss as the deductible amount applied to the policy is increased. At present, we require insurers to provide a disclosure notice to insureds affected by the deductible clause. In the future, as part of the approval process, the Department will require a more detailed notice that includes examples illustrating the triggering event and the applicable dollar amount of the hurricane deductible.

- *NYPIUA's legislative authority should be made permanent in order for it to be able to borrow funds in the event of a catastrophe.*

The Department agrees that NYPIUA should be made permanent and has proposed and supported legislation to achieve this objective.

- *NYPIUA should be required to use a catastrophe deductible program comparable to those in use in the voluntary market.*

The imposition of a mandatory windstorm deductible would constitute an inordinate financial burden upon coastal property owners insured by NYPIUA. NYPIUA's premium requirements are already substantially higher than those in the voluntary market, and the premium for insureds with wrap-around policies is higher still. In addition, in order to qualify for windstorm coverage through NYPIUA, property owners must first incur a substantial expense to obtain an engineering inspection of the property. If the initial inspection indicates deficiencies, the insured must incur additional costs to repair the property or the windstorm coverage will be eliminated from the policy. The imposition of

a mandatory windstorm deductible would add another cost layer at a time that an insured may be least able to afford it.

It should also be noted that the law requires NYPIUA to follow the rates and rules of the principal rate service organization in New York State. This is presently the Insurance Services Office, Inc. (ISO). Since ISO's hurricane deductible rule is optional, the Department could not approve a mandatory rule for NYPIUA. (However, a large hurricane deductible on a strictly optional basis would be feasible.)

- *Actions taken by homeowners to mitigate losses should translate into lower rates, lower deductible options or greater availability.*

Section 2346 of the Insurance Law mandates premium reductions for the installation of hurricane/storm shutters or hurricane resistant laminated windows and doors, but common sense attests to the merits of loss mitigation efforts independent of up-front insurance premium credits. The Department encourages property owners to take all measures to prevent losses before a peril strikes, and insurers should provide information and education to policyholders in order to promote such activity. We also encourage insurers to file rules and rates that provide incentives for premium savings to insureds who initiate loss mitigation efforts.

- *Hurricane/Catastrophe Fund*

A majority of the Panel opposed the establishment of a publicly-funded mechanism for insured catastrophes. The Panel's report described several private sector initiatives that have raised funds in capital markets to help the insurance industry better finance its underwriting risks.

The Department has proposed legislation to permit property/casualty insurers to issue capital notes, and is considering legislation to authorize the licensing of structured reinsurance companies. These proposals would facilitate the securitization of insurance risk, which is essential to the successful development of private sector capital responses.

At present, reinsurance capacity in traditional markets appears to be adequate. However, the viability of catastrophe funding mechanisms (public or private) will not be truly tested until they are subjected to circumstances resulting from an actual claims-triggering event.

SUMMARY

The purpose of this report has been to present the findings of the Department's most recent study of "homeowners insurance market dynamics" in order to assist the Governor and the Legislature in addressing the problems that exist in this market.

Natural disasters and the attention they have captured have adversely affected the market for homeowners insurance in regions of New York that are considered vulnerable to weather-related property damage. Market conditions in the areas of the State focused upon by this study deteriorated in the early years of this decade, but the most recent data provide indications of a gradually mitigating trend. Voluntary market writings appear to have stabilized and modestly increased, and the number of new policies written in the residual market as reflected in NYPIUA's statistics appears to have peaked.

As noted in the Department's previous report, the current problems developed over many years and were the result of many complex factors. It would be unrealistic to believe that those problems will be entirely solved in a short period. In addition, in order to maintain a proper perspective of the problem, we should emphasize that homeowners insurance remains readily available to the vast majority of residents throughout the State.

Though a lack of insurance availability continues for dwellings located closest to the shore, it is important to note that, historically, owners of such properties have had to contend with underwriters' reluctance to assume risk in these areas. Well before the manifestation of the recent crisis, shore-front properties were subject to strict underwriting review even in the residual market.

Measures taken in response to the crisis include establishment of C-MART and CMAP; approval of large hurricane deductibles; promotion of wrap-around policies; introduction of multi-tiered rating; development of requirements for plans of orderly withdrawal from a market; liberalization of the Department's approach to reinsurance costs in the rate making process; and the creation of standby authority granted to the Superintendent to authorize issuance of homeowners coverage by NYPIUA if conditions warrant. These steps, along with the Department's vigilant monitoring of market conditions via on-site examinations and compilation of vital data reported by insurers, and the continued cooperation of the industry, contribute to a sense of cautious optimism for the viability of New York's homeowners insurance market in the future.

APPENDICES

Appendix A - Regulation 154 Collection of Data

Appendix B - Policies in Force and Producer Data by County
October 1, 1996 - September 30, 1997

Appendix C - Policies In Force and Producer Data by Zip Code
October 1, 1996 - September 30, 1997

Appendix D - NYPIUA Policies in Force
December 31, 1990 - December 31, 1997

Appendix E - Statewide Homeowners Policies in Force
January 1, 1992 - January 1, 1997

Appendix F - Long Island Homeowners Policies in Force
January 1, 1992 - January 1, 1997

APPENDIX A

REGULATION 154 COLLECTION OF DATA

The format for the required information collected pursuant to Regulation 154 and Circular Letter No. 10(1996) was as follows:

1. Policies in force at the start of the reporting period.
2. New policies written during the reporting period.
3. Policies voluntarily terminated by the insured.
4. Policies terminated by the insurer under the provisions of Section 3425(b) or (c) of the Insurance law.
5. Policies terminated by the insurer which were not made under the provisions of Section 3425 (b) or (c) of the Insurance Law.
6. Books of business transferred in from another insurer.
7. Books of business transferred out to another insurer.
8. Net policies transferred between counties or zip code.
9. Policies in force at the end of the reporting period.
10. Number of producers authorized to service policies on behalf of the insurer at the start of the reporting period.
11. Number of producers authorized to service policies on behalf of the insurer at the end of the reporting period.

This information must be submitted to the Insurance Department thirty days after the end of each calendar quarter for each county in the state and for zip codes of designated geographical areas. Since this report must be submitted to the Governor and the Legislature on or before February 15, 1998, the Department was able to analyze data only through the calendar quarter ending September 30, 1997.

APPENDIX B

Policies in Force and Producer Data by County
Changes from October 1, 1996 through September 30, 1997

Counties:	(1) PIF Start of Period	(2) Add New Writings in Period	(3) Less Policies Trmntd by Insureds	(4) Less Sec 3425 Trmntns by Company	(5) Less Other Trmntns by Company	(6) Add Policies Transfd in by Company	(7) Less Policies Transfd out by Company	(8) Net Movmnts In (Out) Between Counties	(9) PIF End of Period	(10) Servicing Producers Start of Period	(11) Servicing Producers End of Period
Albany	75686	10047	6506	2061	663	997	872	200	78408	2504	2001
Allegany	11431	1337	774	447	69	191	224	3580	11631	292	263
Bronx	75360	7473	4232	1582	749	1558	1070	1609	79339	367	704
Broome	56990	6704	4526	1123	636	383	228	924	57500	782	671
Cattaraugus	20245	2572	1525	647	148	86	111	580	20445	442	348
Cayuga	18870	2538	1460	586	155	75	68	1296	19172	233	234
Chautauqua	34851	4649	2819	1122	443	469	349	662	35572	845	722
Chemung	22879	2659	1749	573	221	205	156	166	23468	291	258
Chenango	11012	1596	905	378	78	30	33	262	11317	330	372
Clinton	16998	3187	2032	664	193	466	279	170	17541	525	393
Columbia	17940	3026	1851	555	239	623	562	234	18372	377	399
Cortland	10054	1437	974	246	96	53	47	363	10251	194	155
Delaware	13411	1708	1080	421	145	43	40	2331	14336	617	695
Dutchess	70513	9740	5425	2225	586	2065	1926	4945	72958	1564	1382
Erie	268399	34472	20795	7988	1983	2703	2543	167	272819	5797	5306
Essex	13587	2381	1225	508	174	322	244	214	13609	390	157
Franklin	9702	1739	843	393	82	63	41	308	10342	262	149
Fulton	15028	1934	1116	676	149	127	91	220	15106	205	191
Genesee	14984	2027	1244	496	90	173	161	222	15310	586	397
Greene	14280	2566	1192	587	237	185	136	32	15113	615	317
Hamilton	3623	387	248	77	40	49	36	395	3736	39	25
Herkimer	15390	2038	1222	569	218	79	36	833	17020	303	316
Jefferson	20823	3426	2011	935	200	194	119	8189	24181	477	389
Kings	185420	18568	10574	4019	2922	6107	3799	135	196737	756	1284
Lewis	4763	806	494	178	42	61	34	409	5161	129	108
Livingston	14812	2160	1317	420	93	151	159	217	15396	515	379
Madison	16461	2167	1259	678	173	167	119	4100	17428	483	412
Monroe	209540	26530	18029	5029	1124	1979	1964	385	213707	3143	2505
Montgomery	12438	1571	826	505	230	179	99	7286	12272	274	221
Nassau	345846	40597	21170	8683	4446	8940	5680	4149	366406	6890	6806
New York	201246	34457	17237	6501	3321	3121	2219	916	211942	3145	2587
Niagara	61214	7888	4541	2074	385	358	271	1538	61893	756	624
Oneida	58570	7965	4850	2132	608	442	431	1917	61892	1197	959
Onandaga	125430	15839	10187	3475	1051	872	641	557	129718	2147	1879
Ontario	26499	3583	2317	666	188	278	300	3734	27123	547	396
Orange	77689	10963	5605	2414	605	872	663	325	80823	1376	1112
Orleans	9328	1459	803	299	73	37	44	537	9590	76	68

Counties:	(1) PIF Start of Period	(2) Add New Writings in Period	(3) Less Policies Trmntd by Insureds	(4) Less Sec 3425 Trmntns by Company	(5) Less Other Trmntns by Company	(6) Add Policies Transfd in by Company	(7) Less Policies Transfd out by Company	(8) Net Movmnts In (Out) Between Counties	(9) PIF End of Period	(10) Servicing Producers Start of Period	(11) Servicing Producers End of Period
Oswego	25652	3484	2006	650	176	210	141	221	27323	412	358
Otsego	14409	1818	1093	400	146	26	20	632	14701	532	565
Putnam	27230	3610	1881	1107	199	402	351	15801	28296	450	381
Queens	276684	37704	15412	6327	4990	6146	3471	1092	297679	1290	2384
Rensselaer	40505	5881	3695	1293	551	579	477	4351	41749	855	519
Richmond	88260	9927	4655	2146	1449	2258	997	2967	94518	415	621
Rockland	67610	8984	4462	2082	622	1628	1117	438	70861	1151	1156
Saint Lawrence	29343	3998	2217	737	243	72	59	1334	29128	500	361
Saratoga	50840	7712	4587	1434	416	656	561	810	53105	810	905
Schenectady	38375	4547	3060	1171	312	610	424	124	39181	799	707
Schoharie	6240	921	438	238	64	65	48	81	6504	210	215
Schyler	4513	489	352	100	32	46	45	201	4490	78	273
Seneca	10647	1053	749	213	55	29	21	639	10629	149	155
Steuben	24116	3121	1860	830	208	207	226	7703	24780	494	450
Suffolk	371460	47556	23181	10377	5542	13842	8605	654	402216	4731	5151
Sullivan	22569	3589	1735	948	248	538	451	287	22656	480	465
Tioga	11351	1390	849	276	103	47	32	319	11721	165	104
Tompkins	19727	2831	1913	477	201	455	418	1262	20285	449	330
Ulster	46345	6221	3249	1647	466	958	751	422	47212	869	686
Warren	21383	3020	1910	610	170	1594	1541	320	21514	1956	547
Washington	14182	2039	1187	522	137	361	345	549	14616	404	220
Wayne	23032	3294	2070	696	137	379	405	4378	23296	529	363
Westchester	212597	27833	15364	5507	2385	5102	4110	373	223049	5782	4777
Wyoming	9508	1578	802	359	56	80	77	42	10039	288	406
Yates	5372	786	459	108	46	175	175	444	5681	208	120
Z_County Unknown	13201	3817	2554	2938	147	311	312	101541	21550	1097	916
State_Totals	3656464	479916	266738	101609	41968	71461	50975	135	3833605	64572	60427

Note 1: Columns will not cross total by an immaterial amount due to some companies entering or leaving the market during the year.
Note 2: Data drawn from reports of companies which represented approximately 97% of the homeowners market.

APPENDIX C

Policies In Force and Producer Data by Zip Code
Changes from October 1, 1996 through September 30, 1997

Zip Codes:	(1) PIF Start of Period	(2) Add New Writings in Period	(3) Less Policies Trmntd by Insureds	(4) Less Sec 3425 Trmntns by Company	(5) Less Other Trmntns by Company	(6) Add Policies Transfd in by Company	(7) Less Policies Transfd out by Company	(8) Net Movmnts In (Out) Between Counties	(9) PIF End of Period	(10) Servicing Producers Start of Period	(11) Servicing Producers End of Period
06390	380	37	16	15	8	4	2	344	366	1	-1
10301	5600	587	281	119	89	67	60	181	5903	14	51
10302	2862	212	117	82	36	39	55	759	2909	26	39
10303	3119	356	133	97	54	37	43	826	3304	6	31
10304	5871	622	302	137	107	81	75	10	6185	21	67
10305	6961	740	320	168	135	77	62	331	7337	23	89
10306	12427	1317	614	256	222	219	191	23	13250	63	132
10307	2346	274	133	78	49	24	25	293	2527	16	50
10308	6885	667	373	123	85	83	72	206	7287	32	55
10309	5209	709	290	115	96	76	53	8	5694	9	62
10310	4130	340	183	92	60	53	60	216	4253	75	106
10312	13289	1525	657	360	215	183	114	49	14314	34	120
10314	18794	2012	980	412	278	292	183	64	19876	143	296
10454	196	18	5	5	2	1	2	126	211	0	12
10462	5759	561	331	105	54	80	70	24	5977	20	91
10464	1046	98	73	18	24	31	32	134	1077	8	17
10465	7477	782	423	146	83	169	178	5	7823	42	101
10473	3279	321	149	78	27	36	35	70	3525	2	59
10474	109	16	1	5	0	12	9	209	134	14	8
10475	3652	276	176	64	47	69	52	429	3790	4	49
10538	5055	712	439	111	65	112	108	167	5350	412	314
10543	4763	636	338	97	68	70	64	2	4986	184	174
10573	7167	823	447	175	121	104	87	78	7313	95	123
10580	4918	729	422	180	90	137	122	25	5029	49	59
10801	5658	706	376	154	49	97	99	5	5891	129	150
10803	3189	417	245	77	40	103	106	55	3369	104	106
10805	3277	398	257	101	35	58	65	199	3355	68	62
11001	6931	720	417	129	71	89	58	-2	7290	156	183
11003	8482	973	550	218	134	135	118	72	8921	26	99
11010	6518	769	403	229	61	177	132	53	6910	64	168
11020	1798	206	84	353	23	31	22	89	1638	8	27
11021	5272	758	444	168	57	70	60	132	5568	181	205
11023	2385	316	138	70	32	39	24	123	2555	14	38
11024	1821	217	125	55	33	27	19	166	1904	0	15
11030	4983	560	299	142	68	94	79	73	5294	187	197
11040	11471	1228	659	203	124	161	116	281	12112	141	207
11042	19	5	3	9	0	2	2	337	19	194	167

Zip Codes:	(1) PIF Start of Period	(2) Add New Writings in Period	(3) Less Policies Trmntd by Insureds	(4) Less Sec 3425 Trmntns by Company	(5) Less Other Trmntns by Company	(6) Add Policies Transfd in by Company	(7) Less Policies Transfd out by Company	(8) Net Movmnts In (Out) Between Counties	(9) PIF End of Period	(10) Servicing Producers Start of Period	(11) Servicing Producers End of Period
11504	0	0	0	0	0	0	0	84	0	0	0
11507	2160	221	114	41	23	37	24	22	2281	16	29
11509	1005	85	60	27	16	25	25	2	1073	3	21
11510	8702	1027	501	182	136	199	145	268	9263	163	168
11514	1286	152	65	35	10	16	13	171	1416	14	16
11516	1943	249	143	66	29	47	33	204	2068	30	72
11518	3133	356	202	64	62	78	56	244	3315	11	35
11520	8083	919	412	257	157	171	146	25	8465	95	136
11530	7874	973	575	159	102	156	119	49	8609	690	679
11542	5653	749	357	185	53	78	64	28	6246	32	73
11545	3419	441	241	81	55	59	52	26	3641	39	38
11548	339	56	34	14	3	9	3	252	389	8	8
11550	6599	886	356	216	156	85	84	129	7125	79	176
11552	6073	698	396	130	97	139	88	53	6434	109	140
11553	4275	523	198	135	69	76	54	214	4629	32	88
11554	9844	1143	516	210	111	220	150	1	10513	102	137
11557	2319	312	168	68	42	70	60	143	2467	58	73
11558	2015	263	115	53	73	29	31	210	2162	7	27
11559	2085	257	129	70	31	55	47	108	2254	1	27
11560	1852	233	127	53	38	37	27	27	2019	10	17
11561	9497	872	533	259	159	221	208	35	9877	18	111
11563	6052	671	404	118	84	114	86	20	6278	404	382
11565	2796	286	158	56	24	58	43	376	2983	15	34
11566	10430	1093	572	193	115	266	216	131	11125	111	134
11568	828	111	57	44	25	17	12	237	868	2	7
11570	7124	866	454	186	85	230	177	45	7667	160	218
11572	9079	999	532	147	126	253	194	50	9622	23	90
11575	2419	292	95	96	53	49	48	164	2643	2	54
11576	3804	494	252	154	60	88	60	68	4096	54	78
11577	3451	442	241	114	34	72	65	319	3712	159	139
11579	1492	190	94	31	16	32	25	151	1646	12	6
11580	9589	1107	611	230	160	97	126	1	10075	82	131
11581	4922	702	351	140	87	60	58	46	5348	66	108
11590	9264	1044	555	262	109	93	120	157	9893	259	311
11596	2997	302	172	51	33	19	44	92	3137	260	250
11598	3423	490	244	91	50	36	42	145	3732	7	50
11691	3174	268	123	120	94	69	78	321	3334	1	59
11692	685	31	16	16	18	9	9	27	719	0	27
11693	1405	94	60	27	49	41	43	355	1431	1	26
11694	3114	313	139	73	104	55	67	32	3519	18	94
11696	564	32	44	15	11	15	12	206	561	5	10
11697	1834	89	67	29	19	24	27	58	1968	0	17

APPENDIX D

NYPIUA POLICIES IN FORCE

DECEMBER 31, 1990 - DECEMBER 31, 1997

TERRITORY	12/31/97	12/31/96	12/31/95	12/31/94	12/31/93	12/31/92	12/31/91	12/31/90
BRONX	3,579	3,439	3,165	2,981	2,939	2,956	3,038	3,252
BROOKLYN	17,721	17,210	16,128	15,400	15,558	15,882	16,466	17,404
MANHATTAN	1,435	1,491	1,590	1,687	1,736	1,845	1,969	2,140
QUEENS	9,885	8,698	6,635	5,163	4,566	4,225	4,061	4,311
STATEN ISLAND	1,674	1,440	1,064	761	618	581	516	546
ROCKLAND	227	206	182	154	147	138	140	142
WESTCHESTER	711	651	534	442	428	389	401	414
NASSAU	5,333	4,282	2,597	1,528	1,079	797	734	762
SUFFOLK	10,953	9,477	7,152	5,360	4,483	3,932	3,730	3,698
ALBANY CITY	234	229	227	220	226	208	205	243
BUFFALO CITY	2,836	3,106	3,261	3,658	3,952	3,726	3,674	4,013
ROCHESTER CITY	1,474	1,370	1,374	1,271	1,183	977	917	958
SYRACUSE CITY	577	589	553	539	513	384	337	375
ALL OTHER	4,946	4,602	4,248	3,867	3,738	3,578	3,381	3,459
TOTAL STATE	61,585	56,790	48,710	43,031	41,166	39,618	39,569	41,717

Zip Codes:	(1) PIF Start of Period	(2) Add New Writings in Period	(3) Less Policies Trmntd by Insureds	(4) Less Sec 3425 Trmntns by Company	(5) Less Other Trmntns by Company	(6) Add Policies Transfd in by Company	(7) Less Policies Transfd out by Company	(8) Net Movmnts In (Out) Between Counties	(9) PIF End of Period	(10) Servicing Producers Start of Period	(11) Servicing Producers End of Period
11050	7590	899	550	222	83	199	155	93	7883	146	117
11101	862	105	56	23	14	8	9	259	917	3	25
11102	2137	217	141	54	25	25	27	225	2236	9	30
11105	4005	365	220	120	26	34	42	173	4250	9	109
11106	2586	322	142	53	36	34	39	73	2796	15	53
11201	6279	973	487	155	78	92	93	290	6574	27	92
11205	953	120	55	26	13	5	9	121	988	0	24
11208	4427	317	160	115	78	31	38	183	4696	0	92
11209	9719	923	518	182	111	136	182	553	10165	139	196
11211	3548	511	220	125	65	135	156	104	3835	4	48
11214	7629	602	363	172	112	123	158	41	7806	30	110
11215	6340	894	403	189	76	77	96	909	6703	6	59
11220	4441	295	178	91	48	67	84	485	4587	66	130
11222	2190	234	96	84	40	24	28	779	2252	3	36
11223	8131	872	472	221	124	142	174	27	8439	36	114
11224	3753	207	144	70	65	104	112	49	3795	0	38
11228	6168	572	343	113	83	106	125	272	6544	17	89
11229	12133	1029	621	204	169	192	215	105	12596	20	121
11231	2637	380	170	68	29	32	41	274	2757	15	33
11232	1071	87	49	13	17	11	15	0	1108	0	22
11234	16833	1582	815	346	228	218	266	139	17725	53	183
11235	10190	912	552	176	183	167	205	296	10668	32	119
11236	11400	1096	723	328	175	231	244	125	11919	27	130
11237	726	64	18	20	13	21	18	45	792	0	20
11239	453	39	21	15	9	12	13	315	452	1	8
11354	5830	637	318	132	107	92	69	253	6145	67	116
11356	3316	346	186	83	54	22	17	145	3462	27	56
11357	9894	1099	524	181	108	113	95	5	10631	38	151
11359	28	2	1	7	1	0	0	494	23	0	1
11360	5815	758	418	142	84	75	62	374	6121	15	75
11361	6195	700	397	135	95	65	55	663	6489	36	118
11362	4504	609	259	83	42	61	37	480	4878	3	41
11363	2412	238	127	74	21	24	21	2	2516	12	41
11368	4189	381	180	97	142	65	61	1	4368	7	85
11369	3333	330	124	73	83	41	40	26	3519	3	58
11370	3053	301	185	63	41	43	26	13	3210	68	111
11371	20	6	2	5	0	0	0	277	46	0	1
11413	6703	735	190	179	178	114	104	18	7497	3	112
11414	6837	814	351	156	114	126	122	39	7362	10	137
11420	6435	755	314	175	191	85	96	73	7095	7	110
11422	5045	602	191	135	118	147	50	255	5760	18	107
11430	22	6	0	2	0	0	3	83	34	0	5

Zip Codes:	(1) PIF Start of Period	(2) Add New Writings in Period	(3) Less Policies Trmntd by Insureds	(4) Less Sec 3425 Trmntns by Company	(5) Less Other Trmntns by Company	(6) Add Policies Transfd in by Company	(7) Less Policies Transfd out by Company	(8) Net Movmnts In (Out) Between Counties	(9) PIF End of Period	(10) Servicing Producers Start of Period	(11) Servicing Producers End of Period
11701	5064	704	309	176	82	143	112	126	5492	29	72
11702	4146	411	248	90	46	143	98	17	4525	123	122
11703	5454	659	332	131	77	252	161	61	5996	9	47
11704	8226	978	505	247	106	276	139	427	8780	14	81
11705	2023	321	124	67	36	115	80	22	2306	21	36
11706	11767	1480	716	403	198	428	321	16	12773	100	166
11709	1968	195	94	52	19	56	52	192	2087	1	4
11710	9818	1068	576	211	114	243	154	13	10481	146	218
11713	1911	267	115	50	50	59	40	295	2098	5	24
11714	6270	854	343	155	65	138	98	6	6821	66	88
11715	1279	162	50	42	32	53	43	160	1398	4	4
11716	2389	329	161	69	34	111	74	146	2647	41	116
11717	8468	1126	529	325	174	268	164	158	9116	8	80
11718	946	103	50	29	11	52	40	225	1034	7	13
11719	869	114	52	35	14	32	22	66	959	2	7
11720	6746	768	370	179	82	184	115	132	7362	40	61
11721	1991	271	129	55	31	83	73	8	2179	27	26
11722	6076	781	341	237	118	186	119	44	6590	30	86
11724	871	113	57	32	12	35	25	172	971	9	7
11725	8464	1096	578	167	93	237	167	72	9264	133	136
11726	3826	425	190	125	61	86	58	31	4068	8	34
11727	6158	1003	457	212	97	164	96	161	6675	29	60
11729	7176	836	437	192	99	359	216	80	7711	56	106
11730	3827	494	247	92	48	256	168	142	4150	68	60
11731	8389	1114	524	200	118	258	152	273	9233	63	72
11732	1085	140	79	36	13	28	21	44	1164	11	13
11733	4429	626	307	135	49	144	98	56	4913	103	135
11735	8250	952	482	207	81	164	114	66	8801	172	196
11738	3652	460	237	97	60	118	65	33	4007	13	40
11740	2525	351	163	55	35	118	91	79	2759	85	110
11741	6999	979	470	196	74	254	148	41	7727	57	70
11742	2865	373	174	75	39	93	49	324	3094	30	54
11743	12128	1751	848	293	167	563	425	359	13285	506	523
11746	16114	2028	1016	439	256	612	402	289	17445	220	285
11747	3499	524	206	110	32	121	87	121	3919	314	305
11751	3757	476	234	89	72	291	242	179	4096	42	76
11752	2491	286	132	55	40	131	87	49	2690	20	35
11753	3491	522	265	97	49	88	61	-4	3755	217	207
11754	4770	637	317	103	68	136	86	37	5471	42	52
11755	2673	368	170	70	32	65	38	68	2949	4	23
11756	12128	1157	582	270	125	264	186	77	12715	41	127
11757	11070	1264	701	330	149	278	194	46	11689	59	135

Zip Codes:	(1) PIF Start of Period	(2) Add New Writings in Period	(3) Less Policies Trmntd by Insureds	(4) Less Sec 3425 Trmntns by Company	(5) Less Other Trmntns by Company	(6) Add Policies Transfd in by Company	(7) Less Policies Transfd out by Company	(8) Net Movmnts In (Out) Between Counties	(9) PIF End of Period	(10) Servicing Producers Start of Period	(11) Servicing Producers End of Period
11941	550	65	30	6	8	20	23	66	611	2	5
11942	1631	172	95	46	24	27	28	15	1750	0	1
11944	1222	172	66	22	34	28	36	18	1480	35	27
11946	4652	418	245	108	47	65	54	2	4684	17	16
11948	397	58	11	9	4	9	7	86	412	0	1
11949	2630	445	174	68	34	82	51	25	2862	18	27
11950	3082	351	133	98	59	103	81	6	3272	4	35
11951	2954	275	144	96	53	156	149	1	3083	17	21
11952	1938	252	111	60	27	39	37	184	2068	98	84
11953	2728	454	207	92	56	74	44	28	2998	13	31
11954	2757	232	124	71	35	73	70	11	2877	43	45
11955	682	86	42	15	11	14	12	3	720	0	3
11957	476	50	27	7	9	13	15	4	546	0	0
11961	4384	504	310	113	57	88	52	14	4672	11	24
11963	3281	366	169	73	43	61	46	31	3742	16	17
11964	1265	712	68	1278	28	43	39	70471	1324	1	1
11965	538	864	14	1791	6	47	45	101549	589	0	0
11967	5468	817	272	154	97	231	165	-1	5813	24	57
11968	5378	610	282	116	83	130	117	0	5864	32	42
11971	2556	319	156	40	81	51	40	1	2988	14	18
11976	1095	149	77	33	31	30	28	-3	1168	1	6
11977	933	115	64	20	13	5	8	0	1038	15	8
11978	1603	172	89	46	34	24	18	2	1754	45	47
11980	989	150	69	38	16	28	9	3	1091	0	7
Other ZIP Codes	2607114	357815	205194	75264	26587	46970	31667	-37	2709566	51406	38660
State Totals	3656464	479916	266738	101609	41968	71481	50975	135	3833605	64572	60427

***Note 1:** Columns will not cross total by an immaterial amount due to some companies entering or leaving the market during the year.*
***Note 2:** Data drawn from reports of companies which represented approximately 97% of the homeowners market.*

APPENDIX E

Statewide Homeowners Policies in Force January 1, 1982 to January 1, 1987

Company	1982	Gain/Loss 1982 to 1983	% Change	1983	Gain/Loss 1983 to 1984	% Change	1984	Gain/Loss 1984 to 1985	% Change	1985	Gain/Loss 1985 to 1986	% Change	1986	Gain/Loss 1986 to 1987	% Change	1987
Amex Assurance	225	247	[illegible]	472	[illegible]	[illegible]	[illegible]	1310	[illegible]	[illegible]	387	[illegible]	2754	344	[illegible]	[illegible]
Interboro Mut Ind Ins Co.	0	7736	[illegible]	7736	-413	-5.34%	7323	316	4.32%	7639	583	7.63%	8222	456	[illegible]	[illegible]
Heritage Mutual Ins. Co.	[illegible]	-130	[illegible]	3142	[illegible]	[illegible]	82	[illegible]	[illegible]	34	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Home Mut Ins. Co.	11374	-380	-3.34%	[illegible]	167	1.43%	11101	[illegible]	[illegible]	[illegible]	-4464	-42.80%	6101	[illegible]	[illegible]	[illegible]
	3143	[illegible]	[illegible]	[illegible]	94	2.70%	[illegible]	770	21.57%	[illegible]	1944	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
N Y Central Mut Fire Ins. Co.	160147	[illegible]	1.56%	[illegible]	[illegible]	2.41%	173404	[illegible]	[illegible]	[illegible]	[illegible]	5.44%	193447	[illegible]	4.57%	[illegible]
Otsego Mut Fire Ins. Co.	12391	[illegible]	-4.70%	[illegible]	-165	-1.37%	[illegible]	1448	12.13%	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Pawtucket Mutual Ins.	5776	[illegible]	[illegible]	4707	-346	[illegible]	4561	[illegible]	4.57%	4780	631	[illegible]	[illegible]	158	[illegible]	[illegible]
Preferred Mutual	30177	1755	[illegible]	[illegible]	[illegible]	10.10%	[illegible]	-1246	[illegible]	[illegible]	[illegible]	[illegible]	31347	70	[illegible]	[illegible]
[illegible] Mut Fire Ins Co.	0	11599	[illegible]	11599	[illegible]	4.57%	[illegible]	775	[illegible]	[illegible]	[illegible]	[illegible]	13943	[illegible]	[illegible]	[illegible]
Security Mut. Ins. Co.	[illegible]	[illegible]	[illegible]	[illegible]	474	1.32%	[illegible]	[illegible]	[illegible]	[illegible]	134	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
State-Wide Insurance Co.	245	27	[illegible]	313	40	[illegible]	362	245	67.63%	[illegible]	632	104.12%	1239	1274	102.82%	2513
Sterling Insurance Company	39119	[illegible]	21.10%	40116	[illegible]	1.41%	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	31193
Tri-State Consumer Ins. Co.	1082	165	15.14%	1231	166	15.27%	1410	[illegible]	15.70%	[illegible]	441	26.17%	2126	[illegible]	[illegible]	[illegible]
Utica First Ins. Co.	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	811	[illegible]	17424	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Aetna Group	[illegible]	[illegible]	-4.34%	295411	-21399	-7.21%	274106	-12262	-4.47%	261953	[illegible]	[illegible]	[illegible]	[illegible]	-102.82%	0
Allstate Group	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	745309	[illegible]	[illegible]	726470	-30141	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Andover Grp	[illegible]	1071	[illegible]	31447	-316	-1.01%	31129	[illegible]	-0.31%	31034	1225	[illegible]	22296	1475	4.57%	23738
Atlantic Cos	[illegible]	[illegible]	[illegible]	29470	-1373	[illegible]	29105	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Amica Mut Assurance Co.	[illegible]	179	[illegible]	[illegible]	201	0.73%	[illegible]	314	[illegible]	29140	531	1.47%	29571	416	1.13%	[illegible]
Central Mut Ins Co.	[illegible]	[illegible]	[illegible]	[illegible]	-412	[illegible]	107	[illegible]	[illegible]	[illegible]	[illegible]	-91.30%	5	611	[illegible]	[illegible]
Chubb Group	61713	[illegible]	17.70%	62463	-1917	-2.90%	[illegible]	3012	[illegible]	63463	[illegible]	2.17%	63799	3437	[illegible]	67196
[illegible] Group [illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	-0.10%	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	16.70%	[illegible]	[illegible]	[illegible]	[illegible]
Commercial Union Grp	[illegible]	16747	[illegible]	62169	10677	17.10%	72827	7829	10.76%	[illegible]	-819	-0.77%	[illegible]	[illegible]	-6.72%	73865
[illegible] Grp	27919	-74	[illegible]	27845	[illegible]	[illegible]	[illegible]	[illegible]	-12.79%	21492	-21492	[illegible]	0	0	[illegible]	0
Empire/Allcity Grp	7589	28	[illegible]	7610	1641	21.56%	9521	-6387	-67.37%	3044	11699	286.42%	16763	6512	41.34%	22295
GA Cumberland/All co.s	170144	[illegible]	3.94%	160407	-14498	-8.30%	160491	[illegible]	-12.35%	142999	-6172	[illegible]	139913	-14489	-10.44%	124025
Safeco	76591	7649	10.00%	62463	1236	2.00%	[illegible]	-5338	-6.31%	79160	-7449	-9.41%	71711	-29611	-41.16%	42099
The American Group/ Hanov	[illegible]	-4706	[illegible]	[illegible]	-4706	[illegible]	[illegible]	-4613	-2.70%	82786	[illegible]	-4.79%	[illegible]	-1172	[illegible]	42099
ITT Hartford	[illegible]	-2912	[illegible]	[illegible]	[illegible]	[illegible]	164571	1621	0.97%	[illegible]	1936	[illegible]	167939	0	[illegible]	167939
Kemper Group	67670	[illegible]	[illegible]	[illegible]	1701	2.70%	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	5.12%	70410	1999	2.70%	72322
Liberty Mut Fire Ins. Co.	62463	70904	113.70%	133367	836	0.63%	134163	510	0.38%	134696	-311	-0.23%	134382	[illegible]	4.14%	139944
Nationwide Mut Fire Ins. Co.	[illegible]	[illegible]	[illegible]	175669	14891	[illegible]	190139	10706	[illegible]	[illegible]	[illegible]	1.37%	[illegible]	10657	[illegible]	216017
Royal Group	77096	[illegible]	2.49%	79436	11396	14.34%	[illegible]	-12702	-13.90%	79126	-3767	-4.81%	74369	-189	[illegible]	74191
St. Paul Group	[illegible]	[illegible]	11.10%	6646	1499	24.47%	7495	[illegible]	10.60%	8571	925	10.80%	[illegible]	147	1.56%	9412
Sentry Ins. A Mutual Co.	1966	-252	-12.80%	1716	-254	-14.80%	1462	-231	-15.80%	1231	-135	-10.97%	1096	-46	-3.70%	1050
State Farm Group	[illegible]	17066	4.30%	[illegible]	21239	4.80%	461729	19444	4.30%	471172	13430	2.85%	484602	12952	[illegible]	497234
TIG Group	7649	1727	22.60%	9489	2682	27.10%	12168	1062	8.73%	13229	1236	9.30%	14465	-3216	-22.30%	11249
USF & G Group	[illegible]	-482	[illegible]	26979	-1049	[illegible]	27931	1321	3.40%	[illegible]	[illegible]	17.61%	49152	7499	[illegible]	[illegible]
USAA Group	30662	765	2.31%	34723	947	2.73%	36670	1076	3.02%	36746	156	0.42%	36902	6672	18.08%	43574
Utica Mut Grp	[illegible]	2206	11.58%	22296	6309	17.30%	22296	4162	11.86%	[illegible]	166	0.47%	[illegible]	255	0.71%	[illegible]
Maryland Grp	17669	4999	24.57%	21669	4699	21.30%	26017	8499	31.63%	[illegible]	-16795	-47.60%	16392	-1014	-6.72%	16775
CNA Group	[illegible]	2349	4.30%	[illegible]	1712	2.74%	[illegible]	-442	[illegible]	[illegible]	[illegible]	-8.30%	[illegible]	18417	31.73%	76482
Merchants Grp	[illegible]	-1999	-7.40%	[illegible]	-1311	[illegible]	22191	-731	[illegible]	21489	[illegible]	[illegible]	17961	13495	75.44%	31317
Colonial Penn Ins Co.	19541	-1491	-7.60%	18449	-1170	-6.34%	17279	-165	-1.00%	17087	448	2.65%	17556	[illegible]	[illegible]	13691
Metropolitan P & C	67469	11068	16.00%	[illegible]	12165	17.60%	[illegible]	1099	1.40%	[illegible]	-4163	-5.00%	79047	17363	22.30%	36919
Worcester Ins. Co.	[illegible]	1282	5.73%	29166	466	1.57%	29165	240	1.01%	29070	29070	94.60%	47449	[illegible]	[illegible]	[illegible]
Prudential P & C Ins. Co.	[illegible]	8574	9.30%	100725	1679	1.70%	107007	-565	-0.62%	107052	-3621	-3.30%	103431	-2289	-2.21%	101142
National Grange Mut Ins. Co	[illegible]	[illegible]	[illegible]	[illegible]	3075	[illegible]	[illegible]	759	[illegible]	[illegible]	97	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Vanguard Group	3757	1616	43.01%	5373	4999	74.01%	9330	-66	-0.72%	9330	1129	12.10%	10459	-2372	-22.60%	[illegible]
American Loyalty Ins. Co.	230	16	7.00%	247	87	[illegible]	384	1	0.26%	385	-385	-100.00%	0	0	[illegible]	0
Providence Mut Fire Ins. Co.	266	79	21.94%	436	28	6.34%	462	28	6.06%	468	436	88.70%	925	787	85.08%	1712
Republic Group/ Blue Ridge	35712	-4582	-13.11%	31030	1044	6.00%	35074	65	0.29%	35730	2299	6.00%	[illegible]	-3011	-10.31%	31416
Fireman's Fund	19627	462	2.86%	19669	317	1.67%	19936	1069	5.00%	21006	129	0.61%	21135	1600	7.57%	22735
[illegible] Grp	8480	-1891	-22.30%	6389	-1405	-22.31%	6166	-1166	[illegible]	3017	-52	-1.38%	3865	-674	-17.44%	3191
Cigna Grp	[illegible]	-11491	-30.23%	26516	-1160	-4.37%	25356	-885	-3.47%	24470	-8289	-33.76%	16216	2726	16.81%	18942
Providence Washington	2994	[illegible]	296.17%	11796	-227	-1.93%	11539	-520	-4.41%	10916	-9617	-87.19%	1399	579	41.42%	1977
Total	3344094	[illegible]	10.69%	3701136	22942	0.62%	3724069	-11054	-0.30%	3712914	-43336	-1.17%	[illegible]	-4886	-0.13%	[illegible]

APPENDIX F

Long Island Homeowners Policies in Force January 1, 1992 to January 1, 1997

Company	1992	Gain/Loss 1992 to 1993	% Change	1993	Gain/Loss 1993 to 1994	% Change	1994	Gain/Loss 1994 to 1995	% Change	1995	Gain/Loss 1995 to 1996	% Change	1996	Gain/Loss 1996 to 1997	% Change	1997
Amex Assurance	22	34	154.55%	56	134	239.29%	190	500	263.16%	690	64	9.28%	753	62	8.62%	818
Commercial Mut Ins Co.	0	62	100.00%	62	31	50.00%	93	491	527.96%	584	290	51.20%	886	371	42.02%	1254
Heritage Mutual Ins. Co.	42	-7	-16.67%	35	7	20.00%	42	-19	-45.24%	23	109	473.91%	132	-28	-21.21%	104
Home Mut Ins. Co.	590	419	70.25%	1013	363	35.14%	1380	-301	-21.88%	1063	-494	-46.28%	574	-14	-2.44%	560
Interboro Mut Ind Ins Co.	1995	111	5.56%	2106	47	2.23%	2153	436	20.25%	2589	1043	40.28%	3632	414	11.40%	4046
N Y Central Mut Fire Ins. Co.	2538	692	27.37%	3230	613	18.98%	3833	1570	40.96%	5403	2226	41.19%	7629	2733	35.83%	10361
Otsego Mut Fire Ins. Co.	3007	-130	-4.32%	2877	66	2.29%	2943	923	30.41%	3866	1262	33.77%	4128	1228	29.75%	5356
Pawtucket Mutual Ins.	2123	-192	-9.04%	1931	0	0.00%	1931	417	21.60%	2348	159	6.77%	2507	-611	-24.37%	1896
Preferred Mutual	2812	-5	-0.18%	2874	108	3.74%	2982	-225	-7.57%	2757	-400	-14.50%	2297	-313	-13.63%	1974
Quincy Mut Fire Ins Co.	1	86	106.66%	87	-30	-34.48%	57	-1	-1.75%	56	2	3.57%	58	201	346.55%	259
Security Mut. Ins. Co.	675	99	14.67%	774	246	31.78%	1019	900	88.70%	1919	-16	-0.83%	1602	436	27.22%	2038
State-Wide Insurance Co.	78	25	32.05%	103	35	34.00%	139	188	135.25%	327	399	122.02%	726	885	121.90%	1611
Sterling Insurance Company	774	170	22.01%	944	187	19.78%	1130	-155	-13.91%	975	-160	-16.04%	819	105	12.80%	931
Tri-State Consumer Ins. Co.	330	21	6.15%	351	36	10.23%	389	129	32.33%	528	256	48.48%	784	141	17.98%	925
Utica First Ins. Co.	2452	24	0.98%	2476	-18	-0.73%	2458	316	12.86%	2774	335	12.07%	3111	375	12.05%	3486
Aetna Group	54604	-8479	-15.53%	46205	-5174	-11.20%	41031	-3975	-9.69%	37056	-1357	-3.66%	35699	-35699	-100.00%	0
Allstate Group	204162	-8364	-4.10%	195798	-18504	-9.45%	177274	-13661	-7.71%	163616	-11872	-7.26%	151701	-6582	-4.34%	145166
Andover Grp	3108	686	22.10%	3786	632	16.70%	4417	1386	31.54%	5810	1972	33.94%	7782	1809	23.29%	9591
Atlantic Cos	8380	-678	-7.83%	8102	-349	-4.27%	7833	-1102	-14.07%	6731	-1656	-24.55%	5075	236	4.65%	5311
Amica Mut Assurance Co.	4736	21	0.44%	4757	96	2.02%	4853	102	2.10%	4955	185	3.73%	5140	120	2.33%	5260
Central Mut Ins Co.	104	-30	-28.21%	75	-25	-33.33%	50	-45	-90.00%	34	-30	-88.24%	4	-1	-25.00%	3
Chubb Group	8480	1636	19.72%	10116	-416	-4.11%	9700	605	5.85%	10469	740	6.94%	11300	123	1.09%	11522
Travelers Group	24666	-1936	-7.85%	22730	-2190	-9.63%	20540	-3574	-17.37%	17066	-2307	-13.51%	14759	30435	206.21%	45144
Commercial Union Grp	13044	4696	36.25%	17890	3646	20.61%	21336	1573	7.37%	22909	218	0.94%	23127	-1236	-5.44%	21888
Continental Grp	8919	372	4.13%	9291	-1120	-11.99%	8271	-1999	-24.17%	6272	-6272	-100.00%	0	0	0.00%	0
Empire/Allcity Grp	974	149	15.30%	1123	582	51.86%	1705	-1004	-58.89%	701	2100	299.57%	2801	1663	59.37%	4464
GA Combined/All co.s	23595	-1332	-5.65%	22264	-3533	-17.33%	18731	-2387	-12.90%	16344	-468	-4.38%	14876	-1535	-10.35%	13158
Geico	11694	1489	12.56%	13183	401	3.08%	13584	-763	-5.80%	12771	-1300	-10.23%	11466	1371	11.96%	12836
The American Group/ Hanov	17404	-2337	-13.21%	15167	-1941	-12.01%	13216	-461	-3.48%	12755	-723	-5.66%	12063	-494	-4.11%	11569
ITT Hartford	26093	1330	5.10%	27423	2791	10.18%	30214	1386	4.59%	31600	-2386	-7.55%	29214	3837	13.13%	33051
Kemper Group	6499	886	12.86%	7285	804	11.10%	8330	1633	19.14%	9942	265	2.66%	9768	-847	-8.68%	8943
Liberty Mut Fire Ins. Co.	10460	30317	284.43%	40676	163	0.40%	41136	38	0.09%	41174	619	1.50%	41793	2491	5.96%	44284
Nationwide Mut Fire Ins. Co.	12902	416	3.30%	13088	3426	26.79%	16234	4100	25.00%	20436	7313	35.84%	27716	3038	10.96%	30754
Royal Group	21516	-198	-0.79%	21300	-241	-1.13%	21119	-1040	-4.92%	20079	-3187	-15.88%	17892	-1896	-10.60%	15996
St. Paul Group	6300	375	11.86%	3766	1222	32.45%	4988	875	17.57%	5863	429	7.38%	6264	229	3.66%	6493
Sentry Ins. A Mutual Co.	360	-41	-11.82%	315	-43	-13.65%	272	-40	-14.71%	232	-16	-6.90%	216	-6	-2.78%	210
State Farm Group	107298	3865	3.60%	111063	6742	6.07%	117805	6626	5.44%	124391	3464	1.60%	126855	3865	3.05%	130750
TIG Group	2153	633	29.40%	2816	956	33.95%	3772	628	16.65%	4400	-2907	-66.07%	1493	2073	114.00%	3575
USF & G Group	2247	-193	-8.59%	2054	-182	-8.86%	1872	-39	-2.08%	1833	244	13.31%	2067	949	45.87%	3016
USAA Group	9478	187	1.97%	9665	290	3.30%	9955	477	4.79%	10432	131	1.26%	10563	792	7.50%	11355
Utica Mut Grp	6380	338	5.30%	6411	1963	28.79%	8594	1997	20.67%	9731	-40	-0.47%	9686	62	0.34%	9737
Maryland Grp	2167	1400	64.61%	3567	2188	61.36%	5775	3631	62.87%	9406	-2290	-68.62%	6526	1676	30.25%	8602
CNA Group	12976	18475	142.38%	31453	2037	6.48%	33490	826	2.46%	34313	-3701	-10.79%	30612	2669	8.72%	33281
Merchants Grp	7969	-632	-6.60%	7287	196	3.00%	7483	159	2.12%	7642	-284	-3.72%	7358	1778	24.16%	9136
Colonial Penn Ins Co.	5830	-276	-4.73%	5554	-360	-4.10%	5300	270	5.36%	5647	656	10.61%	6102	-1163	-16.90%	4969
Metropolitan P & C	17630	8661	16.18%	20700	2304	11.98%	23153	-1763	-7.99%	21390	-2212	-10.36%	19138	1525	7.97%	20663
Worcester Ins. Co.	9612	391	2.05%	9888	267	2.60%	10160	230	2.17%	10370	390	3.76%	10760	-42	-0.39%	10658
Prudential P & C Ins. Co.	13602	1155	8.36%	14747	1433	9.72%	16180	138	0.85%	16318	-1007	-6.17%	15311	-595	-3.87%	14716
National Grange Mut Ins. Co	601	32	5.41%	623	144	23.11%	767	161	20.99%	928	136	14.66%	1064	-392	-36.84%	672
Unigard Group	1074	446	41.53%	1520	1014	66.71%	2534	-14	-0.55%	2520	326	12.94%	2846	-234	-8.22%	2612
American Loyalty Ins. Co.	11	17	154.55%	28	13	46.43%	41	-7	-17.07%	34	-34	-100.00%	0	0	0.00%	0
Providence Mut Fire Ins. Co.	22	3	13.64%	25	-1	-4.00%	24	11	45.83%	35	32	91.43%	67	84	125.37%	151
Republic Group/ Blue Ridge	7401	-1344	-18.16%	6057	1108	18.31%	7165	650	9.07%	7815	934	11.95%	8750	-60	-0.69%	8690
Fireman's Fund	2902	75	2.58%	2977	513	17.23%	3490	730	20.92%	4220	-33	-0.78%	4187	1141	27.25%	5328
PMI Grp	1908	-538	-27.88%	1370	-321	-23.43%	1049	-369	-35.04%	780	212	27.18%	992	-133	-13.41%	859
Cigna Grp	12316	-5621	-45.64%	6694	-390	-5.83%	6304	617	9.79%	6921	-988	-14.28%	5933	-882	-14.87%	5051
Providence Washington	1313	4193	319.35%	5506	-47	-0.85%	5459	-353	-6.47%	5106	-5106	-100.00%	0	0	ERR	0
Total	707473	45854	6.48%	753327	1324	0.18%	754651	-275	-0.04%	754376	-25570	-3.39%	728806	16811	2.31%	745617

TEMPORARY PANEL ON HOMEOWNERS' INSURANCE COVERAGE

A Report to Governor Pataki and Members of the New York State Legislature

February 1, 1998

Superintendent of Insurance
Neil D. Levin
Chair, Temporary Panel

STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

February 1, 1998

To Governor George E. Pataki and Members
of the New York State Legislature

In accordance with Chapter 66 of the Laws of 1997, I hereby submit the Report of the Temporary Panel on Homeowners' Insurance Coverage.

The first meeting of the panel took place on October 23rd. Subcommittees subsequently met and the panel held full meetings on November 5th, December 4th, January 8th and January 21st. The members are all experienced, knowledgeable insurance people. They were assisted by staff from trade associations, the New York Property Insurance Underwriting Association and the Insurance Department.

I would like to thank the members of the panel for the time and energy they have devoted to assembling this comprehensive report.

Sincerely,

Neil D. Levin
Chair, Temporary Panel

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TEMPORARY PANEL ON HOMEOWNERS' INSURANCE COVERAGE

A Report to Governor Pataki and Members of the New York State Legislature

February 1, 1998

Superintendent of Insurance
Neil D. Levin
Chair, Temporary Panel

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Executive Summary

State of the Market Subcommittee

- The State of the Market Subcommittee was formed to examine historical events and trends relating to homeowners insurance, analyze the current market and offer recommendations to enhance the availability and affordability of homeowners' insurance in New York State.

- Up until the early 1990s, homeowners insurers tended to overlook geographic concentration of risk when writing business in New York State. Fortunately, however, the latter half of this century has been a relatively inactive period for hurricanes in the New York area. As a result, insurers whose risks were overly concentrated in shoreline areas suffered no significant financial penalty.

- The availability of homeowners insurance in coastal communities reached its low point in the mid-1990s and *is now expanding.* The New York Property Insurance Underwriting Association (NYPIUA), New York's insurer of last resort, reports declines in new residential policies in all seven of New York's coastal counties between 1996 and 1997, indicating an increase in writings in the voluntary market.

- Availability problems still affect new business in areas located within 1,500 feet of coastal waters in Long Island and parts of New York City.

- NYPIUA should be made permanent and be authorized to use catastrophe deductibles comparable to those in use in the voluntary market.

- Hurricane deductibles and appropriate "buy-back" options should be approved for every homeowners insurance policy to enhance availability.

Mitigation Subcommittee

- The Mitigation Subcommittee was formed to evaluate the current status of the mitigation effort and to help identify public and private actions that can help mitigate catastrophe risk in the future.

- New York State needs to establish a uniform building code. *This is a critical step toward a successful mitigation effort.*

- Actions by homeowners to mitigate losses could translate into lower rates, lower deductible options and greater availability.

- At the local and state level, there are incentives--such as exempting the value of any mitigation-related improvements to one's home from property tax increases--that could be used to encourage property owners to mitigate against future loss.

- Insurance companies need to establish and promote mitigation efforts.

- Mitigation efforts should also be recognized by financial institutions providing loans with loss-mitigated properties as collateral.

Capital Markets Subcommittee

- The Capital Markets Subcommittee was formed to explore various non-traditional methods of funding catastrophic risk. Capital market funding of catastrophic exposures may take many forms, including securitization; options, futures and swaps; capital and surplus notes; and liquidity facilities provided by commercial banks.

- Capital markets funding for catastrophic loss is a developing market. Recent deals involved the transfer of hurricane risk and earthquake risk.

- The liquidity of the market for catastrophe-linked securities will develop as more sizable transactions are completed and a secondary market in such securities develops.

- The U.S. Treasury needs to address several income tax issues to enhance the efficiency of catastrophe-linked debt securities. Most notably, investment returns from such securities should not be subject to a corporate "entity level" tax.

- The capital markets are far more attractive to investors than public sector catastrophe funds, primarily due to the fact that public sector funds tend to concentrate, rather than geographically diversify, risk.

- The Insurance Department is seeking legislation to permit property/casuaity insurers to issue capital notes.

- The Insurance Department should work with the insurance, banking and investment banking communities to develop private sector mechanisms for risk transfer and risk management.

TEMPORARY PANEL ON HOMEOWNERS' INSURANCE COVERAGE

Preface

This report is submitted pursuant to Section 4 of Chapter 66 of the Laws of 1997, which directed the special advisory panel established pursuant to Section 12 of Chapter 42 of the Laws of 1996 to make an additional report to Governor Pataki and the Legislature on the problems affecting the availability and affordability of homeowners insurance in New York State.

In accordance with the Legislative requirements, the Panel consisted of fourteen members, including the Superintendent of Insurance, who chaired the Panel. Pursuant to the originating 1996 statute, Governor Pataki appointed three members, as did the Temporary President of the Senate, and the Speaker of the Assembly. In addition, the Minority Leader of the Senate and the Minority Leader of the Assembly appointed two members each. Within the New York State Insurance Department (the Department), an internal task force was formed to assist and coordinate the Panel's activities. The members of the internal task force, chaired by Deputy Superintendent Mark L. Gardner, were Wayne Cotter, Janet Glover, Elise Liebers, Kathleen McQueen, Maurice Morgenstern, and Michael Moriarty.

The Superintendent wishes to thank the following individual members of the Panel for their participation and generous contribution of time and effort in helping to accomplish the Panel's mission:

John R. Cashin	Willis Faber North American, Inc.
John P. Ecker	John Ecker, Inc.
Jeffrey Greenfield	NGL Group, LLC
Howard I. Honig	Honig Insurance Agency, Inc.
John B. Johnson	Johnson & Johnson Agency, Inc.
Shelly H. Kozel	Lezok, Ltd.
Mark Kriss, Esq.	Kriss, Kriss & Brignola (Alliance of American Insurers)
Peter Lefkin	Fireman's Fund Insurance Co.
David G. Nadig	Allstate Insurance Co.
Daniel Robinson	New York Central Mutual Fire Insurance Co.
James E. Ryman	State Farm Insurance Co.
George D. Yates	Dayton & Osborne
Steven Wietlisbach	Travelers Insurance Co.

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The following report was prepared by the Temporary Panel on Homeowners' Insurance Coverage. The Temporary Panel is comprised of thirteen members appointed by Governor Pataki and various members of the New York State Legislature. Although this report was prepared pursuant to meetings conducted in the New York Insurance Department's offices, and this report was published by the Department, the report is not an official publication of the New York State Insurance Department. It is the findings and opinions of the thirteen appointed members of the Temporary Panel, and not those of the Insurance Department, which are reflected herein. Thus, this report should be viewed as the work product of the Temporary Panel on Homeowners' Insurance Coverage and not of the Insurance Department.

In preparing this report, the Panel met in plenary session five times. At the Panel's initial meeting, the Superintendent directed that three subcommittees be formed to study various aspects of the problem in detail: the State of the Market Subcommittee, the Mitigation Subcommittee, and the Capital Markets Subcommittee. The State of the Market Subcommittee addressed market conditions, trends in the marketplace and policy coverage issues. The Mitigation Subcommittee studied means of educating and providing information to consumers on risk management and general insurance topics; means of improving construction standards and building codes to minimize property damage; and other measures that can be taken to prevent or ameliorate damage from natural disasters. The Capital Markets Subcommittee studied means for financing the costs of catastrophes. Expanded reinsurance options, securitization of insurance risks, tax policy, and other legislative options were among the issues to which it addressed its attention.

Members of the Panel served on the subcommittees, which also included non-Panel members. (Subcommittee members are listed in the appropriate sections of this report.) The Panel's report is comprised of the reports prepared by each of the three subcommittees and an analysis of recommendations made in the previous report.

OVERVIEW

Homeowners insurance has been an affordable, readily available, and profitable line of business virtually since its inception. Its roots can be traced to the years immediately following World War II. As an insurance product, it represents a classic example of innovation and of the industry's response to competitive forces and the needs of the market. It was a crucial element in the development of suburban communities throughout the country.

As large numbers of urban apartment dwellers migrated to newly developed housing in rural areas adjacent to major cities, appropriate insurance coverage to protect these new property owners' major investments -- their homes -- became a necessity. Up to that time, the insurance industry was largely organized as monoline companies. Property insurers could not insure casualty lines, and casualty insurers could not insure

property. Homeowners needed both property insurance for perils such as fire, and casualty insurance that covered liability for torts. In order to help insurers meet those needs in an economical manner, laws governing the charters of insurers were relaxed to allow insurance companies to become multi-line carriers. Multi-line insurers developed the homeowners package policy in order to offer coverage against several perils at a lower cost, enabling property owners to purchase all of the coverage to meet their needs more conveniently and less expensively.

Homeowners insurance has remained a profitable line for insurers in New York. The open competitive rating law that was enacted in 1970 has fostered a stable rate environment along with gradual expansion and liberalization of coverage. (For example, guaranteed replacement cost coverage has become a common feature of many homeowners insurance policies as insurers have responded to competitive market forces.) However, the effects of losses elsewhere have been far reaching. Insurers that have experienced extensive losses in other coastal areas have moved to reduce the concentration of their business in New York's coastal areas as well. In addition, the cost of catastrophe reinsurance has increased substantially.

In recent years, natural disasters occurring in various regions of the United States have caused insurers to reassess their homeowners insurance underwriting practices throughout the nation. Though hurricanes Hugo, Andrew, and Iniki, and earthquakes in California, occurred far from New York, they served to draw the insurance industry's attention to the potential havoc a single incident can wreak in any area where policy writing is concentrated. Media attention and advances in meteorological science have turned relatively normal weather phenomena such as *El Niño* into occasions for speculating on their potential effect on insurers' profitability. As a result, though an Andrew-like hurricane has yet to hit New York shores, many insurers have reduced the number of policies they are willing to issue on properties located along New York's coastal areas.

Insurers' actions have followed their analysis of the Probable Maximum Loss, a calculation of the greatest amount of insured losses an insurer would incur if the worst possible storm hit a specified geographical area where it is writing homeowners policies. Some insurers, based upon the concentration of exposure and what they have already experienced in areas hit with large losses, have determined that a severe hurricane in a coastal region of New York would result in losses beyond their capacity to absorb. As a consequence, these companies have reduced their overall writings in Long Island by declining to issue new policies, non-renewing policies on properties located within 1,000 feet of the shore, or by reducing their producer force in some coastal areas.

GOVERNMENT RESPONSES

The states have responded to the homeowners insurance problem in various ways. States such as California and Florida, which have experienced actual catastrophe losses and are prone to earthquakes and weather-related disasters regularly, have had to address these issues in an acute crisis atmosphere. In contrast, New York has been forced to respond to problems that are due largely to the *anticipation* of potentially disastrous effects that have as yet not materialized. However, that potential is serious, because New York's coastal areas are densely populated and highly developed, with homes that are more costly than those located in inland regions.

Upon assuming office, Governor Pataki reviewed the situation faced by the State's coastal residents. Recognizing that free market initiatives offer the best opportunity to achieve an effective and lasting solution, Governor Pataki stressed the importance of participation of the voluntary insurance market in a coordinated program of response. The State's efforts to address the problem were renewed and strengthened.

New York's response encompasses a combination of regulatory and legislative initiatives. The Department established the Coastal Market Assistance Reference Tables, or C-MART, to provide, via a special telephone hotline, the names and phone numbers of insurance companies that had indicated a willingness to insure risks in proximity to the shore. The Coastal Market Assistance Program (CMAP) was established, consisting of a voluntary network of insurers and producers to assist homeowners residing in coastal areas in obtaining insurance. Special deductibles applicable only to the windstorm peril were approved for some insurers as a means of encouraging them to continue to insure properties along the coast. "Wrap-around" policies consisting of property coverage provided by the New York Property Insurance Underwriting Association (NYPIUA) and liability protection by a voluntary insurer were approved.

In addition, Governor Pataki signed into law legislation permitting insurers to file multi-tier rating programs for homeowners insurance, and to strengthen requirements providing for the minimization of market disruptions when insurers seek to withdraw from the homeowners insurance market.

FINDINGS OF THE 1996 TEMPORARY PANEL

The Temporary Panel's first report, submitted to Governor Pataki and the Legislature on October 1, 1996, studied the measures implemented in response to the problem, along with actions taken by other states; the means of providing for the financing of catastrophes; and other intermediate and long term alternatives. The earlier report's recommendations and analysis of subsequent events are contained in the Appendix to this Report.

ADDITIONAL REPORT BY THE SUPERINTENDENT OF INSURANCE

In addition to the establishment of this Temporary Panel, Chapter 42 of the Laws of 1996 required the Superintendent to study and report upon the market dynamics of homeowners insurance and policies written, non-renewed or canceled in designated regions of the State, in order to assist Governor Pataki and the Legislature in addressing the problem. The Superintendent's report, which was submitted on February 15, 1997, discussed the causes of the problem and the various measures described above that have been implemented in response to it, and analyzed other relevant issues and possible solutions. Pursuant to Chapter 66 of the Laws of 1997, the Department is currently preparing the next report due on February 15, 1998.

Recommendations of the Temporary Panel on Homeowners' Insurance Coverage

The Panel makes the following non-prioritized recommendations:

Recommendations Related to Market Conditions

- **Hurricane deductibles.** The Insurance Department and insurers should promote more consumer education efforts so that policyholders will understand that with higher deductibles they are assuming a greater exposure than before:

    - The nature, amount and triggering events of deductibles should be prominently and clearly presented to the insured.
    - Percentage deductibles should also be expressed in dollar amounts like traditional deductibles, so that consumers are aware of the full extent of their exposure.
    - Where the deductible applies to one or more "coverage parts," these coverages should be explained, not just referred to as "Coverage A," etc.
    - Also, the nature and location of the triggering event should be clearly explained.

    The Insurance Department's standards for approving deductibles for hurricane losses should include:

    - clear, prominent display of the dollar amount (as well as the percentage) of the deductible on the face of the policy; and
    - clear, prominent explanation of the triggering event.

- **Hurricane deductible triggers.** Panel members (except one) agree that hurricane wind deductible trigger events should be measured solely by:

    - maximum one-minute sustained wind speed at a defined altitude,
    - occurring within a named hurricane, and
    - not by storm surge or barometric pressure measurements.

The Panel members were equally divided on whether triggering events should be named hurricanes with wind speeds in excess of 95 mph (Category 2), thereby assuring that deductibles apply only following catastrophic events.

- **Hurricane deductible buy-backs, new coverage options**. Companies should be encouraged to compete in offering buy-back options to their policyholders who undertake significant mitigation steps, and in developing new insurance products designed to provide coverage for another insurer's deductible.

- **Joint participation on high value homes**. The Insurance Department should work with the industry to find ways to encourage more than one insurer to participate jointly in insuring high value homes. Also, CMAP should consider awarding CMAP credits for participation on this basis.

- **NYPIUA authorization**. NYPIUA's legislative authority should be made permanent in order for it to facilitate liquidity in the event of a catastrophe.

- **Computer modeling**. The Department should consider permitting modeling to be used by insurers as another acceptable actuarial technique for the development of appropriate rates and deductibles. It should consider permitting specific models to be submitted for examination by the Department in support of rate and deductible filings.

  Some Panel members believe the Insurance Department should consider minimum standards for the models used, such as the historical relevance in New York of wind-speed assumptions. Other members feel that a standard of reasonableness is implied in the examination by the Insurance Department of the models and that formal standards should not be set.

- **The Coastal Market Assistance Program (CMAP)**. CMAP should extend its consumer education efforts and coordinate with the Insurance Department and CMAP participating companies in a wide-ranging, broadly available information campaign to address the public's understanding of the relationships among availability, affordability and loss exposure. Specifically, public awareness needs to be increased about:

  * the increasing prevalence of catastrophe deductibles and the need to be alert to changes in homeowners insurance policies which introduce such deductibles;
  * the nature of catastrophe deductibles, what events could trigger such deductibles, and the relationship of these deductibles to availability and affordability of homeowners coverage;
  * how a percentage catastrophe deductible translates into dollar terms, and whether the consumer can afford to assume this exposure to loss;
  * possible mitigation steps homeowners can take, and how such steps could improve the availability and affordability of their homeowners coverage.

The Panel also recommends that the CMAP Steering Committee should explore ways to encourage its participants to provide the broadest possible coverage form generally available in the industry to consumers.

- **NYPIUA deductibles**. Legislation should be enacted authorizing NYPIUA to use a catastrophe deductible program comparable to those being used in the voluntary market.

- **Hurricane/catastrophe fund**. A majority of the Panel opposes establishing a catastrophe fund. (See "Possible solutions" for the majority/minority position statements.)

Recommendations Related to Mitigation Activities

- **Building Codes** A critical recommendation of the Panel is adopting and enforcing performance-based building codes and uniform building codes throughout coastal New York and New York State. Enforcement at the local level is essential.

- **Effective Mitigation Incentives** There is a need for a range of public and private incentives to encourage homeowners (of existing homes) and home builders and buyers of new homes to retrofit or purchase homes which offer protection against the exposure of hurricane and high wind loss as well as other exposures related to living in coastal areas.

    * Public sector solutions should include tax incentives for mitigation of loss. These should include exemption from real estate tax assessments on improvements and real estate tax reductions to reflect the value of mitigation, sales tax incentives for approved or certified retrofitting of existing homes, and income tax credits for purchasing or retrofitting existing homes.
    * Requiring a certain wind resistant performance standard before coverage would be available in the New York Property Insurance Underwriting Association remains a public incentive for mitigation that could be transferred to private sector insurance in terms of encouraging underwriting along the coast or underwriting with varying market deductibles or premium credits.
    * An economic strategy should be put into effect by insurers to ensure that mitigation is a reasonable and economical choice for the coastal homeowner, buyer, or builder.

- **Coordination at the State Level** Government activities in the area of mitigation should be coordinated, along with the mitigation resources of insurers, financial institutions and the private sector (e.g., home building suppliers selling materials and products to retrofit existing homes).

- **Research and Development**

  - Access to and support of research and development of building products and techniques should be encouraged.
  - A consistent means to evaluate the beneficial impact of mitigation actions and their cost to the consumer needs to be implemented.
  - Development of cost-effective and damage reducing building products and techniques for new construction and retrofitting to existing structures should be tailored to the specific risk's characteristics.
  - A standard means of measurement using computer modeling and expert opinion can determine risk of loss for the individual property and for the community as a whole and the cost/benefit of taking mitigation actions.

- **Awareness** All the stakeholders, beginning with the property owner, need to be made aware of the risk of loss for each location and what can be done to lessen it. Public awareness campaigns to convince property owners that mitigation is the right thing to protect their families, their possessions, and their community can be developed. Pamphlets and other materials should be produced to describe the risk, including a general assessment for the individual and for the community in which they live.

- **Education** In addition to building an awareness of the threat, there is a need for all the stakeholders to know where and how to build structures, given the risk of loss from likely natural hazards. Understanding the reasons for mitigating and the impact of taking action are important parts of the education process.

  - Education should be targeted to the stakeholders, consumers and their children, builders and inspectors, insurers and reinsurers, and regulators and others sworn to uphold the public's trust.
  - Educational material could include "how-to" guides on where to build and how to build new or strengthen existing structures to withstand loss.
  - Educational efforts could also be directed to the benefits and costs of taking alternative mitigation actions, the various methods of financing mitigation action, identifying intangible benefits of mitigation to the owner and occupants, and mitigation's impact on availability and affordability of homeowner insurance in hurricane-exposed regions.

TEMPORARY PANEL ON HOMEOWNERS' INSURANCE COVERAGE

State of the Market Subcommittee Report

February 1, 1998

STATE OF THE MARKET SUBCOMMITTEE REPORT

Panel Members:

Shelly H. Kozel, Lezok Ltd., Chairman
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I. Purpose of the Subcommittee

The State of the Market Subcommittee of the Temporary Panel on Homeowners Insurance was organized on October 23, 1997 to study the homeowners insurance market in coastal areas of New York State.

The Subcommittee was charged with examining:

- historical events and trends;
- current market status, including any market conditions which currently present problems for consumers, the insurance industry and/or the state's official policymakers; and
- possible solutions to such problems.

Finally, the Subcommittee was charged with formulating recommendations and presenting them to the full Panel for inclusion in the report mandated by Chapter 66 of the Laws of 1997.

It is the consensus of the Subcommittee that, overall, market availability has improved greatly since the first report of the Temporary Panel was issued in October 1996. However, problems remain for certain properties. These problems, possible solutions and recommendations are discussed below.

II. History of Homeowners Insurance Market Conditions in New York's Coastal Areas

A. Unprecedented natural disaster losses require reassessment of homeowners insurers' exposure

Reassessment of financial exposure. Starting with Hurricane Andrew, which devastated south Florida in 1992, a process of reevaluation and readjustment began. This process affected coastal homeowners insurance markets from the Gulf of Mexico through New England, including coastal markets in New York.

Hurricane Andrew, with about $15.5 billion in insured losses, together with a spate of other natural disasters including Hurricane Iniki (1992, $1.6 billion) and the Northridge, California earthquake (1994, $12.5 billion), alerted property insurers and their regulators to reexamine traditional assumptions and methods used in calculating insurers' financial exposure from natural disasters.

As insurers undertook their reassessments, many began to realize that their true exposure was greater than previously thought; in some cases, companies found that their exposure was unacceptably high. This realization, which also implied that corrective action was needed, posed problems for insurance company decision-makers, who are accountable to policyholders and investors for sound financial management. A slightly different set of problems faced insurance regulators, who are accountable to the public for protecting insurer solvency; for assuring that premiums are neither inadequate, excessive nor unfairly discriminatory; and for preventing disruptive market conditions.

Throughout this process, New York's insurance regulators have taken the general position that insurers' exposure in New York's coastal areas resulted from a long, gradual build-up of insured value and market share; and that sudden, disruptive market actions would be an unacceptable corrective approach. At the same time, New York policymakers have taken a series of steps designed to help insurance companies adjust their coastal exposures to appropriate levels over time, while maintaining availability and affordability of homeowners insurance coverage.

To understand these steps and how each has contributed to the readjustment process and current market status, a brief look at the nature of homeowners insurance is in order.

<u>**What is homeowners insurance?**</u> "Homeowners insurance" contracts are "package" policies that bundle together several different kinds of insurance protection for a single premium. The major coverage components protect against damage, disappearance or destruction of the policyholder's property ("property coverage"); and provide legal

defense and funds to pay claims if the policyholder injures someone or damages their property ("liability coverage").

In recent decades, homeowners insurance coverage has been so widely and economically offered that most property owners have taken its availability for granted. However, prior to the development of the "package" policy as a marketing strategy and policyholder convenience, these separate kinds of insurance were available under separate policies, from separate companies. Property coverage generally was inferior to the levels provided in today's homeowners contracts. For example, fewer hazards or "perils" were insured against, and the policy paid only for the market value of the building and/or contents, not the cost of replacing them. As more enhancements were added to the homeowners package over time, some analysts believe that insurers did not adequately consider the overall exposure they were assuming and price their products accordingly.

Historical underwriting trends. Historically, the major peril concerning householders and property insurers was fire. Property insurance underwriters carefully tracked the location of the buildings they insured, avoiding insuring adjacent houses or several structures in the same block, for fear of sustaining large losses from a single conflagration.

As modern heating and lighting methods reduced the frequency of house fires, and as the homeowners package replaced "fire" policies, underwriters shifted away from their former focus on "mapping." Now a return to this underwriting focus on the geographic spread of risk, updated with modern computer technology, has helped homeowners insurers reassess their actual coastal exposure in recent years. However, these techniques, and the corrective actions their findings have implied, have not been without controversy.

In New York State, as elsewhere along the Eastern seaboard, a relatively inactive period for tropical storms throughout the latter half of this century minimized the financial penalty for insurers' inattention to geographic concentration of risk. At the same time, the state experienced unprecedented development in coastal areas and skyrocketing market values for homes built desirably close to the views and recreational opportunities of open water. These trends contributed to an explosion of insured property value located "in harm's way," i.e., in the path of coastal windstorms.

In the absence of actual catastrophic storms, and in view of the historical profitability of the homeowners product, insurers are thought by some to have concentrated more on gaining market share than on maintaining a prudent geographic distribution of risk. At the same time, keen competition drove down profit margins. According to Michael Walters of Tillinghast-Towers Perrin (an actuarial firm), in states that had not experienced much loss in the past 30 years, "insurers had lapsed into storm amnesia or engaged in wishful thinking that current building codes had solved the problem." Hurricane Andrew provided the wake-up call.

<u>Solvency, financial rating concerns.</u> It is well known that a property-casualty unit affiliated with one of the country's best-known insurer groups would have failed following Hurricane Andrew without a cash infusion from its parent. Other insurers did in fact go under. These insolvencies resonated not just with other insurance companies and regulators, but with the organizations that are supposed to predict such problems. As a result, insurers have seen an increasing emphasis on geography by the firms that evaluate and rate the financial strength of insurance companies. (Walters' comment, quoted above, appeared in the weekly publication of a well-known rating firm, A.M. Best.)

One function of rating organizations is to assign an insurer a simple "rating" value (usually expressed as a letter or letters), a value that represents the outcome of a complex analysis of the company's financial picture. Insurance companies zealously protect their ratings, which affect their public image and policyholder/shareholder confidence. The rating firms' scrutiny as well as the financial concerns of insurers' investors and management have caused homeowners insurance companies to undertake market readjustment actions in coastal areas.

<u>Impact in New York State.</u> Actions taken by insurance companies to adjust their exposure can take several forms. The major types include:

- insure fewer homes in coastal areas;
- receive premiums which adequately reflect catastrophe risk;
- have property owners share the catastrophe risk;
- find traditional or non-traditional business partners to share catastrophe risks; and
- encourage public and private actions to mitigate catastrophe risk.

These last two areas are the focus of the Panel's Capital Markets and Mitigation Subcommittees, respectively. The Market Condition Subcommittee will focus primarily on the remaining three types of action, each of which can impact the availability and/or affordability of homeowners insurance coverage, which are the "market conditions" that most concern consumers and public policymakers. In addition, the Subcommittee will look at certain risk-funding options which would require state action to establish (see "Possible Solutions," below).

B. New York's availability rebounds from mid-decade problems

There are two basic techniques for insuring fewer properties in coastal areas: cut back or eliminate new business writings (and let attrition reduce exposures over time); or begin to drop existing customers.

Either of these strategies can occasion public concern, by making new coverage harder to find or by requiring people to find a new insurer. In the long run, however, it can be sound public policy to allow insurers to find their comfort level in the marketplace and

spread the risk to a greater number of insurers. For example, Florida's Academic Task Force on Hurricane Catastrophe Insurance found that Florida's homeowners market problems have been magnified because of market concentration in a small number of insurers and said that a diverse, unconcentrated market would be more stable. (New York's market never reached the concentration levels experienced in Florida.)

Figures compiled by the New York Insurance Department, (hereinafter "the Insurance Department"), reflecting data from "admitted"--i.e., New York licensed--insurers writing in excess of 95 percent of the statewide homeowners insurance market, suggest that this process is underway in New York State. (See "A Special Report to the Governor and the New York State Legislature on a Study of Market Dynamics of Homeowners Insurance Policies Written, Canceled, or Nonrenewed in Designated Geographic Areas," Feb. 15, 1997; hereinafter "Market Dynamics Report").

The following table compares the numbers of homeowners policies in-force on Long Island for the 10 homeowners insurers writing the most policies there as of year-end 1992, with the number of policies written by these insurers as of June 30, 1996, and as of September 30, 1997:

Company	Year-end '92	6/30/96	9/30/97	% Change 92 to 96**	% Change 96 to 97**
Allstate	204,162	151,741	145,502	-26%	-4%
State Farm	107,258	126,825	133,797	+18%	5%
Aetna*	54,684	35,698	0	-35%	-100%
Hartford	26,093	29,214	31,797	+12%	9%
Travelers*	24,656	14,709	49,030	-40%	233%
General Accident	23,956	14,675	10,914	-39%	-26%
Royal	21,510	17,892	15,033	-17%	-16%
Metropolitan	17,828	19,138	20,483	+7%	7%
American/Hanover	17,464	12,033	9,199	-31%	-24%
Prudential	13,592	15,311	14,360	+13%	-6%
Total	511,203	437,236	430,115	-14%	-2%

* Aetna's homeowners business was acquired by the Travelers. Figures for 1997 are combined with those of the Travelers.
** The exact dates are 12/31/92, 6/30/96 and 9/30/97.

Overall, these 10 insurers covered 81,088 fewer Long Island homes as of September 30, 1997 than they had at year-end 1992. Reductions in homeowners business for these and other homeowners companies resulted from a combination of changes in market posture.

NYPIUA maintains adequate reserves to pay claims in non-catastrophic situations. In the event of a catastrophe causing NYPIUA's losses to exceed its immediately available assets, there could be a delay in paying NYPIUA claims if it needed to use its authority to assess NYPIUA member companies.

A related issue is the ability of NYPIUA to engage in borrowing. Theoretically, NYPIUA could borrow funds to pay its claims more quickly in these circumstances. In practice, NYPIUA is hindered from doing so by its lack of legislative permanence. The Subcommittee determined that this is a significant reason why the Panel should again recommend that NYPIUA be made a permanent residual market like the New York Automobile Insurance Plan.

NYPIUA dwelling policy trends. NYPIUA's original writings peaked in 1971-72 at just over 180,000 policies, then decreased rapidly to around 100,000 policies throughout the period 1976-1988. Then NYPIUA's policy count again fell off, to a low of about 66,000 in 1992. At about this time, NYPIUA began to see a change in the proportion of habitational (dwelling) risks it insured (as compared to its commercial policies), with habitational risks increasing from 68 percent of NYPIUA's total policies in 1990 to 78 percent by the end of July, 1995 ("NYPIUA Expansion" report, p. 5).

Here is a look at NYPIUA's habitational writings (policies in force) for coastal counties (Source: "Trends in Coastal Dwelling Insurance Writings by the New York Property Insurance Underwriting Association," prepared by the NYS Senate Insurance Committee based on data provided by NYPIUA):

	Year-end NYPIUA Habitational Policies In-force				
County	**1993**	**1994**	**1995**	**1996**	**1997**
Bronx	2,939	2,981	3,165	3,439	3,579
Kings	15,558	15,400	16,128	17,210	17,721
Queens	4,566	5,163	6,635	8,698	9,885
Richmond	618	761	1,064	1,440	1,674
Westch'r	428	442	534	651	711
Nassau	1,079	1,528	2,597	4,282	5,333
Suffolk	4,483	5,360	7,152	9,477	10,953
Total	29,671	31,635	37,275	45,197	49,856

A comparison of these figures to those of the Market Dynamics Report (and updated by the Insurance Department through September 30, 1997) suggests that it would be inaccurate to assume that property owners who lose their homeowners insurance all have turned to NYPIUA. For one thing, approximately 136,000 fewer homeowners policies were written by licensed New York companies at the end of the third quarter of 1997 than at year-end 1993 in the seven coastal counties. However, there were only

reduce its homeowners policies to submit a plan of orderly reduction for advance approval by the Insurance Department. The plan must detail how the reduction will be accomplished in a manner that minimizes market disruption. The Department's interpretation of this law was set forth in Circular Letter 10 (1996) and in the promulgation of Regulation 154 on June 25, 1996. The regulation also requires quarterly reporting of homeowners policy data to the Insurance Department for designated geographic areas of the state. These provisions were extended through April 30, 1998, by Chapter 66, Laws of 1997.

As of January 29, 1998, the Department had received and approved only four withdrawal plans covering a total of approximately 7,800 insureds, most of whom were offered comparable coverage by other insurers. Although the criteria for actions requiring the filing of a plan are based on *statewide* net policy reductions, it is possible that this provision has helped stabilize the coastal insurance marketplace since its adoption. (An earlier law, Chapter 683, Laws of 1994, which is not subject to "sunset" [expiration] provisions, empowers the Superintendent of Insurance to declare a temporary moratorium on terminations of homeowners policies in any area of the state where a state of emergency has been declared due to disaster or catastrophe.)

The role of NYPIUA in the state's property insurance market. The New York Property Insurance Underwriting Association (NYPIUA) was organized in 1968, under Article 54 of the Insurance Law. NYPIUA, like similar organizations in other states, was established at a time when civil unrest had caused market conditions that left urban residents unable to secure basic property insurance.

NYPIUA is a joint underwriting association providing basic property insurance. It is made up of all insurers writing direct fire and extended (property) coverage in New York State. These companies participate in the expenses, profits and losses of NYPIUA in proportion to their statewide market share for these lines. Around two percent of the state's residential properties are insured by NYPIUA (compared to the over 15 percent of personal autos insured in the New York Automobile Insurance Plan).

NYPIUA currently is providing a certain amount of coverage for property owners who have tried, but failed, to secure a homeowners policy. For example, the Department has issued guidelines allowing voluntary market insurers to coordinate their policies with NYPIUA's to approximate the coverage package available in a homeowners contract. (This coordination is known as the "wrap-around" approach; see the Temporary Panel's Oct. 1, 1996 report, page 3 for details.) However, there is not an exact numerical correlation between the decrease in voluntary market homeowners policies written by admitted carriers (as reflected in the Market Dynamics Report) and the increase in dwelling policies written by NYPIUA.

NYPIUA's legislative authorization. Currently, NYPIUA's legislative authorization is slated to expire as of April 30, 1998. Periodically, this authorization sunsets, sometimes preventing NYPIUA from accepting new applications until its mandate is renewed.

NYPIUA maintains adequate reserves to pay claims in non-catastrophic situations. In the event of a catastrophe causing NYPIUA's losses to exceed its immediately available assets, there could be a delay in paying NYPIUA claims if it needed to use its authority to assess NYPIUA member companies.

A related issue is the ability of NYPIUA to engage in borrowing. Theoretically, NYPIUA could borrow funds to pay its claims more quickly in these circumstances. In practice, NYPIUA is hindered from doing so by its lack of legislative permanence. The Subcommittee determined that this is a significant reason why the Panel should again recommend that NYPIUA be made a permanent residual market like the New York Automobile Insurance Plan.

NYPIUA dwelling policy trends. NYPIUA's original writings peaked in 1971-72 at just over 180,000 policies, then decreased rapidly to around 100,000 policies throughout the period 1976-1988. Then NYPIUA's policy count again fell off, to a low of about 66,000 in 1992. At about this time, NYPIUA began to see a change in the proportion of habitational (dwelling) risks it insured (as compared to its commercial policies), with habitational risks increasing from 68 percent of NYPIUA's total policies in 1990 to 78 percent by the end of July, 1995 ("NYPIUA Expansion" report, p. 5).

Here is a look at NYPIUA's habitational writings (policies in force) for coastal counties (Source: "Trends in Coastal Dwelling Insurance Writings by the New York Property Insurance Underwriting Association," prepared by the NYS Senate Insurance Committee based on data provided by NYPIUA):

	Year-end NYPIUA Habitational Policies In-force				
County	1993	1994	1995	1996	1997
Bronx	2,939	2,981	3,165	3,439	3,579
Kings	15,558	15,400	16,128	17,210	17,721
Queens	4,566	5,163	6,635	8,698	9,885
Richmond	618	761	1,064	1,440	1,674
Westch'r	428	442	534	651	711
Nassau	1,079	1,528	2,597	4,282	5,333
Suffolk	4,483	5,360	7,152	9,477	10,953
Total	29,671	31,635	37,275	45,197	49,856

A comparison of these figures to those of the Market Dynamics Report (and updated by the Insurance Department through September 30, 1997) suggests that it would be inaccurate to assume that property owners who lose their homeowners insurance all have turned to NYPIUA. For one thing, approximately 136,000 fewer homeowners policies were written by licensed New York companies at the end of the third quarter of 1997 than at year-end 1993 in the seven coastal counties. However, there were only

20,185 more habitational NYPIUA policies in-force in these counties as of September 30, 1997.

The Subcommittee has learned that *new* habitational policies written by NYPIUA in coastal counties reflect a falling demand for NYPIUA's residential coverage in the past year, further reinforcing the evidence of an improving market.

According to figures provided to the Subcommittee by NYPIUA showing new business policies in-force, NYPIUA's new habitational policies in-force declined for all seven coastal counties over the period from 1996 year-end through the end of December 1997. The declines are as shown:

NYPIUA New Business Habitational Policies In-force

County	1996 yr.-end	1997 yr.-end	change
Bronx	777	699	-10.0%
Kings	3,362	2,870	-14.6%
Queens	3,384	2,847	-15.9%
Richmond	636	541	-14.9%
Westch'r	244	209	-14.3%
Nassau	2,139	1,840	-16.2%
Suffolk	3,159	2,804	-11.2%
Total	13,757	11,810	-14.2%

In analyzing this trend in a memorandum to the Subcommittee, NYPIUA President Joseph A. Calvo said, "While new business dwelling policies at December 31, 1997 are greater than as of December 31, 1995, we believe the numbers show a peaking at December 31, 1996 and are now in a downward trend. It is important to note that the downward trend in new business dwelling policies to our in-force is the first indication of a decline since December 31, 1992. The decline in new business applications presently received by this Association of 8 percent in 1997 will ultimately result in renewals trending downward in 1998. The loss of renewals will be accelerated by replacing of renewals in the voluntary market as policies reach their one-year expiration" (January 12, 1998 update re NYPIUA statistics).

Other coverage sources: CMAP. In response to public concerns about homeowners insurance availability, the Insurance Department authorized a Coastal Market Assistance Program (CMAP) and took related steps to help affected property owners. Market assistance programs are temporary voluntary market agreements entered into by insurers, with the approval and oversight of state regulators, to address temporary availability problems for a certain type of coverage.

CMAP, which began operations on March 18, 1996, is administered by NYPIUA. CMAP procedures implemented a commitment by participating insurers to write an

additional 5,000 homeowners policies in coastal areas over a three-year period. Commitments by individual insurers are based on market share. CMAP participants agree to waive their existing underwriting rules regarding coastal proximity in providing CMAP coverage. CMAP commitments can be fulfilled either by entertaining applications outside companies' normal distribution methods (the "rotation" procedure) or by writing additional business through normal distribution channels.

According to figures provided to the Subcommittee by NYPIUA, demand for CMAP coverage through the rotation procedure has been minor (about 334 policies as of December 31, 1997). CMAP's overall rate of production, at 2,143 total policies as of December 31, 1997, has remained at only 70 percent of the production commitments provided for in the CMAP plan of operation, thereby reflecting a resurgence of the voluntary market.

Insofar as NYPIUA's and CMAP's new applications and in-force business are an index of availability in the voluntary market, they reflect a recent improvement of availability. However, as more voluntary market companies introduce hurricane deductible programs (see discussion below), one concern is that the NYPIUA/wrap-around approach will become the more attractive option and that NYPIUA applications will begin to increase. In general, sound public policy dictates that a residual market should not offer terms that are more attractive than those of the voluntary market.

Therefore, the Subcommittee believes that NYPIUA should introduce a catastrophe windstorm deductible program comparable to those being used in the voluntary market.

Other coverage sources: The excess line market. Throughout this discussion, attention has been focused on New York's licensed homeowners carriers and the joint underwriting association (NYPIUA) they support. There is an additional source of coverage for the exposures presented by home ownership: New York's excess line insurers.

Excess line insurance companies are not licensed by New York State. Placement of business in these companies is strictly regulated. Because they are not directly regulated by New York, these companies have greater flexibility in setting their rates and determining the contract terms they offer. Also, these companies' policyholders are not protected by New York's insolvency guaranty fund; nor are these companies required to support this fund or participate in the experience of NYPIUA.

Information provided to the Subcommittee by the Insurance Department, based on data from the Excess Line Association of New York (ELANY), shows an increasing trend in the placement of homeowners business in excess lines companies, with $2.4 million (316 policies) in direct homeowners premium written in 1995 and $3.6 million (673 policies) in 1996.

Historically, excess line insurers have been a resource when admitted markets are scarce. New York's insurance producers are using the excess line market as one more tool to help find coverage. While less convenient and more costly, this process does confirm the availability of homeowners-type coverages for even difficult-to-place risks, which can be accessed by resourceful insurance producers using creative techniques.

Subcommittee's findings regarding market availability. The trends illustrated by the Insurance Department's voluntary market surveys and the NYPIUA and CMAP data summarized above support the consensus of the Subcommittee that market conditions reached their low point at about the middle of the decade and are now on the rebound. The effect of the first market adjustment strategy, i.e., restricting the availability of homeowners policies, has turned the corner and market conditions have improved.

The Subcommittee believes there are still availability problems affecting placement of new business in areas located 0 - 1500 ft. from coastal waters in Long Island and the boroughs of New York City. The remainder of this area is not experiencing an availability problem. Overall, market availability has improved greatly since the first report of the Panel was issued.

Owners of high-value homes (those in excess of $500,000 - $750,000) find that many admitted companies which have been traditional providers of high-value homeowners policies have increased underwriting restrictions and deductible requirements. Owners of high-value homes are more likely than others to have insurance through non-traditional sources such as NYPIUA/wrap-around approaches and the non-admitted (excess line) market. Excess line companies writing high-value homeowners business often are non-admitted affiliates of large, financially secure insurance groups.

C. Do New York's coastal homeowners premiums adequately protect policyholders?

The second strategy by which insurers might undertake to adjust their exposure to loss from natural disasters, including severe windstorms, is to make sure that the premiums they collect from policyholders adequately reflect the potential costs of such a catastrophe.

The average person probably believes that insurance companies should "save up" enough money left over from years when there are no catastrophes to pay claims when disaster strikes, much as a household might lay aside money in good times for a "rainy day." Unfortunately, it is not so simple.

Effect of U.S. tax policy. As discussed the 1996 Panel report (page 6), U.S. tax code effectively prevents insurance companies from adopting this approach. In Walters' discussion of catastrophe rate-making cited above, (*Best Week PC*, Aug. 12, 1996), he explains the problem this way: "Because a catastrophe-free single year generates too

much tax on the catastrophe reserve, a carrier is unable to accumulate the funds to pay for a large event in 100 years on an after-tax basis."

The Subcommittee has identified federal tax policy as one of the single biggest problems contributing to long-term market uncertainty for the homeowners product. While it is beyond the scope of New York state-level policymakers to effect direct change in this area, the Subcommittee urges that this point be kept in the forefront of any further discussion.

Reinsurance costs. If insurers cannot lay aside enough money to cover catastrophic losses from infrequent but severe windstorm events, then how do companies currently fund this exposure?

One strategy used by most insurers is to purchase their own "insurance," known as reinsurance. Homeowners insurers enter into contracts with one or more reinsurers, whereby the reinsurance company agrees to pay for a certain portion of the direct insurer's losses. (This process comes under the heading of "finding traditional or non-traditional business partners to share catastrophe risks," described above. While reinsurance is a traditional approach, other, non-traditional risk transfer strategies were studied and reported upon herein by the Capital Markets Subcommittee.)

Following Hurricane Andrew, reinsurers, like "direct" homeowners insurers, undertook a reassessment of their actual exposure. For a brief time, catastrophe reinsurance became much more expensive and hard to find. Direct insurers' market decisions during this period were, to some extent, driven by the temporary market conditions of their traditional reinsurance partners. (A resource provided to the Panel by the Reinsurance Association of America outlines the rebound of catastrophe reinsurance availability during the 1990's; see "Property Insurance Exposures: Marketplace Responses to Risk Management Challenges," Oct., 1997; hereinafter "Market Responses".

Until comparatively recently, the Insurance Department did not consider the costs posed to direct insurers by the purchase of reinsurance in evaluating homeowners insurance rate filings. According to the Department's Market Dynamics Report (Feb. 15, 1997, page 17), "the Department has recently changed its policy with regard to homeowners rate filings in order to permit insurers to reflect the cost of catastrophe reinsurance. Since February, 1996, when this policy change took place, approximately 12 rate filings which reflect this cost have been acknowledged."

Homeowners rate changes on Long Island, 1994-97. The Subcommittee reviewed the impact of coastal exposure on homeowners rates. At the Subcommittee's request, the Insurance Department furnished members a summary entitled, "Homeowners Rate Increase History—for Selected Groups—File Index from 1/1/94 to Present."

In all, the effects of 24 rate filings for nine company groups are summarized in this document. In nearly every case where both the Long Island and statewide average

effects of the rate filings are shown, Long Island was affected by larger rate increases. The filings generally are based on "loss experience," although the comment on one filing references "reinsurance load" and "ISO's excess wind procedure, grossed up for hurricane loss potential not reflected in ISO's factor."

Modeling techniques and rate-setting. At this point, the Department does not consider the projections generated by "computer simulation modeling" in evaluating rate filings (See the Department's Market Dynamics Report, pages 16-17, for a discussion.) The "modeling" technique is the computer-assisted "mapping" process mentioned above, whereby potential losses arising from the actual distribution of a company's insured properties in a given geographic area are analyzed, using various sets of assumptions about possible occurrences there.

In the wake of Hurricane Andrew, insurance regulators and the public began to hear a lot about companies' "PMLs" or "probable maximum loss." PMLs are projected values generated by modeling.

According to the Insurance Department, "an insurer's probable maximum loss is a calculation of the greatest amount of insured losses an insurer would incur if the worst possible storm hit a specified geographical area where the insurer is writing homeowners policies. The PML is calculated by catastrophe modelers who will isolate a geographical area where the insurer is writing homeowners business, input as much data as is available about the business (number of homes, type of construction, age of homes, distance from the shoreline, etc.) and run up to 6,000 computer variations of a storm against that area. The largest loss amount from a single storm scenario is the insurer's PML" (Market Dynamics Report, p. 12).

The Insurance Department announced at a public hearing on property insurance issues (April 1995) that it was undertaking a study of modeling. A recent presentation by the Department's Anthony C. Yoder, Principal Actuary, describes the difficulties from the regulator's point of view in using modeling information to set rates.

Current methodologies inadequate. Yoder opens by citing insured losses resulting from Hurricane Andrew and other natural disasters, noting that from their magnitude and the resulting insurer insolvencies, "it is easy to see how flawed the methodologies used by most insurers to manage and price for catastrophe risk really have been. . . . [O]ne thing most regulators are convinced of is that current or pre-Andrew catastrophe ratemaking methodologies . . . are not entirely appropriate for projecting prospective catastrophe losses . . . ." ("The Regulators' Point of View on Catastrophe Issues," adapted from a July 29, 1997 presentation by Mr. Yoder to the 3rd Annual Catastrophe Protection Summit).

The presentation cites reasons for the inadequacy of current methods: "scarcity of historical hurricane data in both ISO [Insurance Services Office, a statistical service firm] and insurer bases due to below-average catastrophe activity over the last 20 to 30

years, changes in population demographics, changes in coverage and construction practices, etc."

Difficulties posed by modeling. Yoder's discussion goes on to describe the difficulties in evaluating the outcome of modeling technologies. One problem has been the fact that modeling companies have been reluctant to make available all the details of their methods. The firms believe that this proprietary information (in which they have invested considerable research and development) could become subject to public disclosure laws (such as New York's Freedom of Information law), and hence to competitors, as a result of disclosing it to state regulators. This legitimate business concern has struck critics of modeling as possibly reflecting some deliberate obfuscation as well, especially in light of the hair-raising PMLs generated by some model scenarios.

While it appears feasible to address modelers' disclosure concerns, other concerns remain. These include the challenges of understanding and evaluating a complex technology, plus the inevitable skepticism caused by the inconsistency of outcomes generated by various modeling firms looking at the same insurer's homeowners business.

According to Yoder, "the part of the models which require the most attention and review are the model assumptions since they have proven to be the most sensitive aspect. In concept, catastrophe models are simple in design but, in practice, they incorporate countless assumptions. Adding to this is the fact that meteorologists and engineers cannot even reach agreement within their own fields . . . Knowing this should enable regulators to understand why results can vary substantially among modelers. . . . [S]ince there are so many model parameters where assumptions have to be made, *there is a need to determine what are reasonable ranges of assumptions for each parameter. These ranges will vary from state to state.*" [Emphasis added.]

Subcommittee's finding regarding computer modeling. The Subcommittee believes the Department should conclude its study on computer modeling. The Department should consider permitting modeling to be used by insurers as another acceptable actuarial technique for the development of appropriate rates and deductibles. It should consider permitting specific models to be submitted for examination by the Department in support of rate and deductible filings.

Some Subcommittee members believe that the Department also should proceed to determine formally what are reasonable ranges of assumptions for use in a New York State context; for example, the historical relevance of wind-speed assumptions used. Other members believe that a standard of "reasonableness" is implicit in the Department's evaluation of the specific assumptions in any given model, and that formal standards should not be set.

D. Hurricane deductibles affect more policyholders

The third general market action strategy for adjusting catastrophe loss studied by the State of the Market Subcommittee is the increasing use by insurers of special deductibles. These policy provisions that have the effect of leaving a greater level of catastrophe risk with the policyholder.

In its 1996 report, the Panel recommended that the Insurance Department should approve appropriate mandatory deductibles for "hurricane loss." The report noted that "one of the most significant means of reducing probable maximum losses is the use of large deductibles applicable to catastrophe generated losses. By mandating that every policy contain such a deductible, a company will drastically reduce its insurable losses. The panel strongly recommends that companies file and the Insurance Department approve appropriate large deductibles *for hurricane damage*" [emphasis added] (page 5).

The Panel predicted that this step would produce a marked improvement in availability of homeowners insurance.

<u>**Evolution of hurricane deductibles in New York.**</u> Policy deductibles are contract terms stating that an insurer's obligation to pay claims begins at a certain level of loss (the deductible amount). Claims that do not reach this amount, and damage costs below this amount (when the claim exceeds the deductible) are not paid for by the insurer.

Traditional homeowners contract deductibles have been expressed as relatively low dollar amounts ($250, $500, $1,000), applicable to all damage claims submitted under the policy. Policyholders generally have been offered a range of dollar-amount deductible options at various prices, with lower deductibles costing more.

In its Supplement to Circular Letter No. 11 (1993), the Insurance Department finalized a set of guidelines for homeowners insurers to use in filing for mandatory and optional deductibles applicable to claims for windstorm damage in coastal areas. The Department's guidelines provide for both "non-catastrophic" windstorm deductibles (applied whenever winds *do not* attain Category 2 hurricane status (i.e., sustained winds of 96 mph or more), as determined by the National Weather Service at landfall anywhere in New York State; and for "catastrophic" windstorm deductibles activated only in the event that Category 2 status or higher is experienced at landfall anywhere in New York State. The "Non-catastrophic" guideline for a mandatory deductible is no more than $500.

In addition, the Circular Letter supplement said that "an insurer may, with sufficient support, submit for Insurance Department consideration a windstorm deductible filing that differs from the articulated criteria."

According to the Department, as of Feb. 15, 1997, "20 insurers have received approval from the Insurance Department for their windstorm deductible programs. These programs provide windstorm coverage which is subject to certain mandatory deductibles depending on the geographical location of the risk. The mandatory deductibles range from 1% to 5% of the windstorm loss with optional deductibles available at higher percentages" (Market Dynamics Report, page 14).

Current deductible terms. At the Subcommittee's request, the Insurance Department furnished members information summarizing approved windstorm deductibles as of October 27, 1997. The summaries described 25 deductible filings by individual insurers and two by rate service organizations, which may be used by their member companies. (Filings by the rate service organizations appear to adhere to the Department's pre-approved guidelines.)

The Subcommittee studied the provisions, focusing a great deal of its total discussion on the various deductible programs, particularly the "trigger" provisions (the description of an event that activates the deductible).

Policy language appears to differ from company to company, requiring close attention to the effect of each contract term to understand which policyholders would be affected, and to what extent, by their deductibles in any given storm. The main variables include:

- hurricane category/wind speed;
- deductible amount or percentage; and
- location of affected policies.

Hurricane category/wind speed. Sixteen of the current deductible filings contain triggers below the level of the Category 2 hurricane. At the other extreme, one company's deductible does not apply unless one-minute sustained wind speeds of 100 mph are reached during a hurricane.

There also are parameters in some policies regarding time of loss, relative to the official recording of the triggering event. Most of these policies specify that the deductible applies to losses occurring within 12 hours before or after the trigger; (one filing says 24 hours).

Deductible amount or percentage. The deductibles, ranging from 1% - 7.5%, are expressed as a percentage of the homeowners Coverage A limit, i.e., the value of the insured home (excluding its contents). One company's filing includes a 7.5% hurricane deductible for higher value homes located close to shore. The 7.5% deductible is required for homes having Coverage A (structure) values of $500,000 or more. This is the highest deductible described on the chart.

A policyholder with a $500,000 home insured by this company would sustain $37,500 of loss from a Category 1 hurricane before the insurer would be required to make any payments for the damage.

Seven companies have deductibles of 5%, applicable to some of their policyholders. A 5% deductible for a $250,000 home would be $12,500.

Location of affected policies. The original guidelines in the Circular Letter supplement said that mandatory percentage deductibles should be graduated on a percentage basis, so that they are highest nearest the shore, fade with distance from shore and disappear beyond a mile from shore. As noted, the supplement permitted insurers to submit filings that differ from those guidelines, and sixteen of the filing summaries appear to indicate that deductibles apply beyond one mile from shore.

What is an appropriate deductible "trigger"? It is evident that the contractual language describing the triggering event is extremely important to policyholders, because if this threshold description is met, all policyholders with the deductible provision will be affected, regardless of the amount of their claim or the storm conditions in their specific location.

Since a number of filings reference hurricane "Category" values, the Subcommittee studied the methodology by which an official Category value is assigned to a hurricane. The Category assignment is not dependent upon wind speed alone. Other factors considered include "storm surge," or the degree to which coastal waters exceed normal levels. Since flooding, including damage from wave wash, is not an insured peril under homeowners policies, the Subcommittee agreed that wind speed criteria (and not storm surge) are the correct triggers for the deductibles.

Subcommittee findings regarding deductibles. The State of the Market Subcommittee believes that catastrophe deductibles are having a significant favorable impact on availability, except for new applicants wishing to insure more expensive homes or homes close to the shore. Owners of high-value homes (those in excess of $500,000 - $700,000) are assuming more of their catastrophe exposure due to increased deductibles.

The Subcommittee agreed that wind deductible trigger events should be measured solely by:

- maximum one-minute sustained wind speed at a defined altitude within New York State;
- occurring within a named hurricane; and
- not by storm surge or barometric pressure measurements.

Despite lengthy discussions, Subcommittee members did not agree among themselves on whether a triggering event for mandatory percentage deductibles should involve, at

minimum, a named hurricane having wind speeds at a Category 2 level or higher (i.e., at least 96 mph), as specified in the original guidelines of the Insurance Department. Some Subcommittee members believe that:

- companies should be strongly encouraged to make the amount of their deductibles proportionate to the severity of the triggering event; and that
- triggering events should be named hurricanes with wind speeds in excess of 95 mph (Category 2).

Other Subcommittee members did not agree that the Panel should make these recommendations. Among their concerns is the possible impact of these deductible standards on availability.

As with premium rate filings (discussed above), the Subcommittee believes the Insurance Department should consider permitting computer modeling to be used by insurers in support of their deductibie filings.

<u>Differences between new wind deductibles and traditional deductibles.</u> New York's Insurance Law provides that significant policy changes such as the introduction of new mandatory deductibles can be made only as a homeowners policy completes its three-year "required policy period" (see §3425). This provision means that homeowners insurers must phase in their deductibles over a three-year period following their approval, so that an increasing number of coastal area homeowners policies currently are being changed to include new deductible programs.

The information on deductible provisions provided to the Subcommittee by the Insurance Department shows the wide variety of deductible programs in use today, and the number of specific terms included in each deductible provision. As with any legal contract, an understanding of each term, and of the possible interactions among these terms, is required before insureds can accurately anticipate the effect of a deductible that is added to their policy.

As discussed above, the evolution of the homeowners product has accustomed consumers to assume general standardization among homeowners insurance products and to regard homeowners deductibles as requiring them to assume a relatively low *dollar amount* for each claim. Where consumers have encountered "percentage" requirements, it generally has been in the context of their health benefits programs, where they may be required to pay a percentage of each medical claim. Thus, a casual reference to a "five percent deductible" might be interpreted by some consumers as requiring them to pay five percent of any damage claim.

In contrast to the "percentage of claim" formula familiar to many consumers in these medical co-payment requirements, the new homeowners deductible programs express the amount of the deductible as a percentage of the policy's Coverage A limit. One policyholder notice letter explains the company's program this way: "The 5% Windstorm

Deductible equals 5% of your Dwelling Limit (Coverage A), namely the value of your home as listed on the policy. To show it another way: Coverage A limit X .05 = Amount of Windstorm Deductible." Since this is a generic policyholder notice, the specific dollar amount for the individual policyholder is not shown.

As discussed above, the 5% deductible would equal $5,000 for a $100,000 home; $12,500 for a $250,000 home; $25,000 for a $500,000 home, etc. While described in terms of a percentage of the Coverage A limit, these deductibles typically apply to the total losses from the trigger event, i.e., damage not only to the dwelling structure (Coverage A), but also to any additional structures located on the premises (Coverage B), and to the contents (Coverage C).

(Subcommittee findings regarding policyholder understanding of deductible terms. There was unanimity among Subcommittee members on the subject of consumer education regarding deductible terms. Subcommittee members agreed that more consumer education is needed so that policyholders will understand that they are assuming a greater exposure than before. The Subcommittee believes the Panel should make recommendations designed to improve consumer awareness and understanding of these deductibles. (Deductibles are discussed in the Department's Consumer Guide for Homeowners and Tenants Insurance as well as on its Website-http://www.ins.state.ny.us)

Deductible "buy-back" and supplemental policy options. Some homeowners insurance companies offer their policyholders an opportunity to "buy back" their hurricane deducible. In other words, policyholders are given a choice, for an additional premium, not to accept the deductible or to accept a lower deductible. This choice may be offered on a one-time basis, rather than continuously over the life of the policy. In view of the dollar amounts involved, this is a choice that consumers need to weigh carefully.

The Subcommittee discussed the availability of buy-back options and the potential that some companies might develop additional insurance products that would be specifically designed to provide coverage for the deductible amount under another company's policy.

Subcommittee findings regarding buy-backs, new coverage options. The Subcommittee believes insurance companies should be encouraged to compete in offering buy-back options to their policyholders who undertake significant mitigation steps and/or in developing new insurance products designed to take care of another insurer's deductible.

III. Current Status of Coastal Homeowners Insurance Market Conditions in New York State

As described above, the State of the Market Subcommittee finds that:

- overall market availability has improved greatly since the first report of the Temporary Panel on Homeowners Insurance was issued in October, 1996; there are still availability problems affecting placement of new business in the 0 to 1,500 ft. from shore area of Long Island and the Boroughs of New York City, and for homes with values in excess of $500,000 - $750,000;
- the remainder of this area is not experiencing an availability problem;
- the use of mandatory hurricane deductibles is increasing;
- more consumer education is needed so that policyholders with these deductibles will understand that they are assuming a greater exposure than before;
- many admitted companies that have been traditional providers of high-value homeowners policies (insuring homes valued in excess of $500,000 - $750,000) have increased underwriting restrictions and deductible requirements;
- owners of high-value homes are assuming more of their catastrophe exposure due to increased deductibles;
- owners of high-value homes are more likely than others to have insurance through non-traditional sources such as NYPIUA/wrap-around approaches and the non-admitted (excess line) market; and
- excess line companies writing high-value business often are non-admitted affiliates of large, financially secure insurance groups.

IV. Possible Solutions to Assure Continued Market Availability of Homeowners Insurance in the Future

No discussion of current market conditions should ignore the fact that New York has not recently experienced a severe hurricane.

According to a presentation to the Panel by a modeling expert, over time New York can expect to sustain some degree of hurricane loss every four years. The model used for this presentation projects that New York can expect, on average, a hurricane causing $100 million in insured damage here every 10 years; $700 million every 20 years; $1.6 billion every 33 years; and $3.2 billion every 67 years. Once a century, New York faces insured hurricane damage of $3.9 billion.

Naturally, a hurricane causing this level of damage in New York could be expected to have caused additional devastation elsewhere, further impacting the surplus of New York homeowners insurers writing in multiple states.

The difficulties of providing for enough money to pay claims from catastrophic storms were discussed above. For example, U.S. tax policy allows insurers tax deductions only for losses that have already occurred. As a result, insurers have traditionally relied on surplus to fund natural disaster losses. For some insurers, reliance on surplus is their preferred approach. Others may choose to use reinsurance. Most homeowners insurers today use reinsurance to manage their exposure.

Some of the largest U.S. homeowners insurers, however, have not found it feasible to purchase much reinsurance. For example, in 1995 presentations to the Florida Academic Task Force on Hurricane Catastrophe Insurance, Florida's leading personal lines carriers noted that, at that time, they could not find reinsurance in the large $1 billion and higher amounts (for a single event) which they would need to manage natural disaster risk. According to the Reinsurance Association of America, during this decade's reassessment of risk "some leading personal lines insurers continued -- then and today -- to express concerns about their overexposure in certain geographic areas. Insurers continued to review external and internal means of financing for natural disaster risk; most insurers realigned their risk exposure and reevaluated their reinsurance programs, while some looked for alternatives to traditional reinsurance, particularly those who believed the price of catastrophe reinsurance was equivalent to or higher than their potential cost of capital" (see the RAA's "Marketplace Response" report, pages 1, 3).

The Capital Markets Subcommittee report will review non-traditional options involving private capital transactions. The State of the Market Subcommittee agreed to review the option of establishing some type of catastrophe reinsurance fund through state action, a step that could affect homeowners market conditions if taken.

In some states (Florida, California, Hawaii), in part due to severe market restrictions, legislative action has established a mechanism to fund catastrophe loss (see the Panel's Oct. 1, 1996 report, Appendix A). The Subcommittee considered the pros and cons of recommending that New York consider taking a similar step.

This issue proved irreconcilable for the Subcommittee. A strong majority of the Subcommittee opposes establishing a catastrophe fund, while a minority thinks this topic should be explored further. The Subcommittee agreed to let proponents of these opposing points of view draft position statements for inclusion in its report, and for proposed inclusion in the report and recommendations of the full Panel.

Majority Report of the State of the Market Subcommittee Regarding a Hurricane Reinsurance Fund

The State of the Market Subcommittee has examined the creation of a state-operated hurricane reinsurance catastrophe fund. A super-majority of the subcommittee opposes the creation of a reinsurance fund because it would disrupt the New York homeowners' insurance market and significantly increase the cost of insurance for homeowners. In addition, recent improvement in the Long Island homeowners' insurance market and the private reinsurance market makes a state fund unnecessary.

In lieu of creating a reinsurance catastrophe fund, the Legislature and the Insurance Department should use simple solutions designed to address New York's unique circumstances. Minor repairs to the present system can enhance the industry's ability to provide coverage in catastrophe-prone areas, and can be undertaken quickly with immediate benefits to citizens in localities exposed to hurricanes. Further, they free the majority of the state's citizens from suffering costs they will eventually bear through such a reinsurance fund.

Description of a Reinsurance Fund. Presently, New York insurers purchase reinsurance protection from the private market and only Florida has created a state hurricane reinsurance fund. According to a major investment banking firm, which made a presentation to the Panel, the Florida Hurricane Catastrophe Fund would reimburse $5.6 billion to homeowners' insurers in the event of a 1-in-100 year hurricane striking Florida. Such a hurricane is expected to produce $30 billion in insured losses.

Annually, the Florida Hurricane Catastrophe Fund collects roughly $400 million from insurers based upon their homeowners' writings and commercial-residential writings exposed to the hurricane peril. Insurers automatically pass these costs on to consumers through higher homeowners' insurance rates throughout the state. Over a period of time, money accumulates in the fund. Before a significant amount can accumulate, the fund relies heavily on a level of debt to pay bonds. The major investment banking firm (mentioned above) estimates that the fund has bonding capacity of $5.5 billion which would be financed by an annual 2%-4% emergency assessment levied on all lines of property-casualty insurance (except workers' compensation) in the state for a ten year period. In the event of a $30 billion hurricane, the emergency assessment would increase the cost of homeowners' insurance by $60 per $1,000 in pre-event homeowners' insurance premiums. The Florida fund is not backed by the full faith and credit of the state.

Due to the Florida fund's assessment authority and the huge liability of the residual markets, the major investment banking firm's analysis highlighted that the "day after" a 1-in-100-year Florida hurricane, the hypothetical policyholder would experience a premium increase of 53.5% in the first year and 33.4% from years two to ten. The same firm stressed that state funds are not a panacea and that public policymakers must confront whether to "pay now" or "pay later."

A similar reinsurance fund in New York would reimburse insurers for some of their hurricane losses -- depending upon the amount of money in the fund, the level of the insurer's participation, and the money generated by the annual 2%-4% emergency assessment. If the fund's assets are insufficient to reimburse insurers, the fund would levy an emergency assessment on all New York property-casualty insurers to meet its obligations. This assessment would be automatically passed on to policyholders of New York.

Reinsurance market has expanded; capital markets provide new options. The Subcommittee believes that a reinsurance fund is unnecessary because the private reinsurance market has expanded and the capital markets have begun to offer new financing mechanisms (e.g., securitization of hurricane risk, surplus notes, lines of credit). In the last seven years, the industry's surplus has increased 75% to $280 billion. Similarly, the private reinsurance market has significantly increased its capacity. For example, the Bermuda market created $5 billion in new reinsurance capacity and Lloyd's is once again competitive in the private market. Presently, the cost of reinsurance is back to pre-Hurricane Andrew days and the availability is at a record high of $1 billion per program.

Over the past several years, there has been growing interest in the role of the capital markets in spreading or financing catastrophe risk. According to the major investment banking firm, the sheer size of the capital markets ($13 trillion in U.S. stocks and bonds) should enable the market to withstand the losses associated with a severe hurricane that could cripple one or more individual insurers. In addition, some financial intermediaries maintain that moderate amounts of catastrophe risk in a diversified portfolio can improve overall returns while decreasing portfolio risk. Depending upon an insurer's needs, the securitization of catastrophe risk can supplement an insurer's reinsurance program.

Virtually every major investment bank in the U.S. has formed a group to work on the development of securitized insurance products, and a number of transactions involving individual companies have been completed. For example, the Subcommittee received a report from USAA about its recent securitization of $477 million in Eastern hurricane exposure. Other insurers, such as St. Paul, Swiss Re, and Winterthur, have used similar financial vehicles. It is the major investment banking firm's opinion that the insurance industry will continue to turn to the capital markets and investors are becoming more comfortable with such securitization.

At the very same time insurers are turning to new methods, a state reinsurance fund would force insurers to pay millions into a fund whether or not an insurer needs such reinsurance protection. The proposed fund would impact all insurers -- even those homeowners' insurers that write predominantly in upstate New York.

A fund would promote cross-subsidization among consumers. The Subcommittee believes that a reinsurance fund would have a statewide impact on the market and promote cross-subsidization between policyholders in the state. First, homeowners' insurers would be annually assessed reimbursement premiums by the fund. These fund payments by insurers would be passed on to all New York consumers, including those upstate, as insurers seek significant premium rate increases.

Second, if the fund is forced to levy an emergency assessment, almost all insurance policyholders in the state would be assessed. Because only a limited geographical area in New York is exposed to hurricanes, a statewide 2%-4% emergency assessment on all property-casualty insurers means that policyholders for all lines of property-casualty insurance (e.g., commercial multi-peril, farmowners, auto, surety, etc., except workers' compensation) would bear some of the burden for hurricane losses. This emergency assessment would be annual until covered losses are reimbursed.

A fund would not immediately improve insurance availability. Advocates for a reinsurance fund contend that a fund would have a beneficial impact on the availability of homeowners' insurance. However, the Subcommittee is not convinced that such a fund would improve availability. A fund would be financed by reimbursement premiums collected by insurers and these premiums would accumulate over a period of time. However, it would take a decade before the fund could be considered a "backstop" or have a beneficial impact on the behavior of insurers. In the interim, the fund would rely almost exclusively on a level of debt to pay bonds. Testament to this fact is that Florida consumers continue to experience difficulty obtaining homeowners' insurance even with a hurricane reinsurance fund. Waiting a decade for money to accumulate does not address the immediate needs of coastal New York homeowners.

In addition, in the early years of the fund, insurers would lack confidence in the fund's ability to meet its obligations because of the limited amount of money collected by the fund. The fund would also be viewed as an untested entity. As a result, prudent insurers would still purchase duplicative reinsurance from the private market. Thus, insurers would pay twice for the same reinsurance coverage -- once to the state and once to the private market. Purchasing duplicative reinsurance and the levy of a new charge on insurers could mean the difference of a profitable or unprofitable year.

Conclusion. The Subcommittee believes that a state hurricane reinsurance fund is unnecessary. In addition, state intervention into the reinsurance market is premature. The private reinsurance market has expanded and new financing mechanisms from the capital markets have provided additional alternatives.

Considering the recent improvement in the availability of homeowners' insurance in coastal areas, the creation of a state reinsurance fund is unlikely to improve present availability and it may actually exacerbate the situation. Rather than pursue a state fund, we believe that minor repairs to the present system are the best alternative for quickly addressing the needs of coastal New York.

Minority Report of the State of the Market Subcommittee Regarding a Catastrophe Fund

The State of the Market Subcommittee recommended against further study of a catastrophe fund for New York. Following is the minority's (Allstate Insurance Company) contrary view:

It might be premature to recommend the establishment of a catastrophe fund for New York, but it is short-sighted to reject further investigation of the concept. A catastrophe fund is a state-administered, tax-exempt trust fund that would reimburse private insurers for a certain percentage of losses incurred in a large catastrophic event. Such a fund could add considerably to the stability of the New York property insurance market.

The creation of a catastrophe fund is a complex and delicate calculus requiring significant actuarial and financial analysis. After careful study, Florida successfully developed a formula for a catastrophe fund that helped restore some normalcy to the most dysfunctional property insurance market of all time. In light of the success of a catastrophe fund in Florida, the Subcommittee should not cavalierly dismiss a catastrophe fund for New York without more in-depth study.

The Florida experience. In August of 1992, Hurricane Andrew destroyed much of south Florida. It caused $10 billion of insured residential property losses and $16 billion of total insured losses. In all, eleven insurance companies were declared insolvent. Some insurers filed petitions with the Department of Insurance to stop writing property insurance. Many more started to reduce their exposure to large catastrophes by engaging in mass nonrenewals of existing customers. Virtually no one could purchase a homeowners policy in the private market.

In 1993, the state created the Florida Hurricane Catastrophe Fund, a state-administered reinsurance program for residential property. Today the fund has a claims-paying capacity of $7 billion, the equivalent of 70 percent of the residential losses from Hurricane Andrew. After Hurricane Andrew, insurers were fleeing the state. Within a few years of establishing a catastrophe fund in Florida, most insurers stopped their nonrenewal programs and new companies started applying for licenses to write homeowners insurance. The Florida market still has problems, particularly in southeast Florida, but the state sponsored Academic Task Force on Hurricane Catastrophe Insurance concluded that the fund was "a significant contributor to the stability of the private insurance market in Florida because of its unique ability to accumulate reserves on a tax-free basis and to leverage those reserves into sources of cash for paying claims."

The New York market never disintegrated like the Florida market. It has not experienced a major catastrophe like Hurricane Andrew or the Northridge Earthquake in California. But the experts agree that the potential is there. Let us not lapse into

complacency over *El Niño*. Prior to 1989, no catastrophes ever caused insured losses above $1 billion. Since then, multi-billion dollar losses have become common throughout the world: Hurricane Andrew ($16 billion in 1992); Northridge Earthquake ($10 billion in 1994); Hurricane Hugo ($4.2 billion in 1989); Hurricane Iniki ($1.6 billion in 1992). In Europe, Typhoon Mireille caused $5.2 billion of insured losses and the winter storms in Continental Europe were responsible for $4.6 billion of insured losses.

The prudent course of action is to prevent a market meltdown after a major catastrophe. A catastrophe reinsurance fund could do just that.

The opponents. Opponents of a catastrophe fund argue that it is a bail-out for large insurance companies. No one is asking for a hand-out. Insurance companies would be required to pay an actuarially sound premium to the state-administered fund. These premiums would be exempt from federal income tax as they accumulate and earn interest. The fund, therefore, would be able to build surplus to pay claims much more rapidly than would a private insurance company, which is required to pay federal income tax on the same dollars.

In the early stages of a catastrophe fund, the bulk of the claims-paying capacity is achieved through the issuance of bonds after a catastrophic event. The bonds are paid for by adding a small surcharge to insurance premiums. In Florida, the surcharge ranges from two to four percent on all property and casualty insurance premiums, excluding workers' compensation insurance. Opponents argue such a surcharge is tantamount to a tax increase, resulting in upper New York subsidizing the metropolitan area.

A surcharge may be a tax, but every tax must be evaluated on its own merits. The catastrophe fund surcharge would go into effect only after a major catastrophic event causes large insured losses. The money is being used to help people rebuild their homes and repair or replace their personal property. Is this an inappropriate use of public funds?

The subsidy argument is premature. The bulk of New York's population is concentrated in metropolitan New York and Long Island, where the catastrophic risk is obviously the greatest. The size of the metropolitan area could adequately support a bonding program without impacting the residents of upper New York. Additional actuarial and financial analysis should be done to determine whether it would be necessary to subject the residents of upper New York to any surcharges. It may be possible to construct a bonding program without affecting those lines of business. But the Subcommittee would prefer not to engage in this inquiry. What do they have to fear?

Lower reinsurance costs. Perhaps the private reinsurers fear losing business.

A catastrophe fund is remarkably cost efficient. In Florida, most private reinsurers charge a "mark up" of two to three times the rates being charged by the catastrophe fund. Those higher reinsurance costs get built into the rates of any homeowners insurer which relies on reinsurance. A catastrophe fund introduces more competition to the reinsurance marketplace.

A catastrophe fund does not replace traditional reinsurance, but augments it. Many companies will still need to rely heavily on the reinsurers to provide reinsurance coverage that "wraps around" the coverage provided by a catastrophe fund. In general, however, homeowners insurers can rely less heavily on the more expensive private reinsurers. It's not surprising, therefore, that most of the opponents to a catastrophe fund are reinsurers or those companies that are closely affiliated with reinsurers.

Conclusion. A catastrophe fund would provide a cost-efficient way for the tax-free accumulation of surplus to pay claims to property owners in the event of a major hurricane in New York. Such a fund could provide billions of dollars of additional capacity to the New York property insurance market. Any additional capacity would improve competition, ultimately resulting in improved availability of homeowners insurance.

The potential benefits of a catastrophe fund are too great not to study them in more detail.

V. Recommendations of the State of the Market Subcommittee

- **Hurricane deductibles**. The Insurance Department and insurers should promote more consumer education efforts so that policyholders will understand that with higher deductibles they are assuming a greater exposure than before:

  - The nature, amount and triggering events of deductibles should be prominently and clearly presented to the insured.
  - Percentage deductibles should also be expressed in dollar amounts like traditional deductibles, so that consumers are aware of the full extent of their exposure.
  - Where the deductible applies to one or more "coverage parts," these coverages should be explained, not just referred to as "Coverage A," etc.
  - Also, the nature and location of the triggering event should be clearly explained.

The Insurance Department's standards for approving deductibles for hurricane losses should include:

- clear, prominent display of the dollar amount (as well as the percentage) of the deductible on the face of the policy; and
- clear, prominent explanation of the triggering event.

- **Hurricane deductible triggers.** Panel members (except one) agree that hurricane wind deductible trigger events should be measured solely by:

  - maximum one-minute sustained wind speed at a defined altitude,
  - occurring within a named hurricane, and
  - not by storm surge or barometric pressure measurements.

The Panel members were equally divided on whether triggering events should be named hurricanes with wind speeds in excess of 95 mph (Category 2), thereby assuring that deductibles apply only following catastrophic events.

- **Hurricane deductible buy-backs, new coverage options.** Companies should be encouraged to compete in offering buy-back options to their policyholders who undertake significant mitigation steps, and in developing new insurance products designed to provide coverage for another insurer's deductible.

- **Joint participation on high value homes.** The Insurance Department should work with the industry to find ways to encourage more than one insurer to participate jointly in insuring high value homes. Also, CMAP should consider awarding CMAP credits for participation on this basis.

- **NYPIUA authorization.** NYPIUA's legislative authority should be made permanent in order for it to facilitate liquidity in the event of a catastrophe.

- **Computer modeling.** The Department should consider permitting modeling to be used by insurers as another acceptable actuarial technique for the development of appropriate rates and deductibles. It should consider permitting specific models to be submitted for examination by the Department in support of rate and deductible filings.

  Some Panel members believe the Insurance Department should consider minimum standards for the models used, such as the historical relevance in New York of wind-speed assumptions. Other members feel that a standard of reasonableness is implied in the examination by the Insurance Department of the models and that formal standards should not be set.

- **The Coastal Market Assistance Program (CMAP).** CMAP should extend its consumer education efforts and coordinate with the Insurance Department and CMAP participating companies in a wide-ranging, broadly available information campaign to address the public's understanding of the relationships among availability, affordability and loss exposure. Specifically, public awareness needs to be increased about:

    * the increasing prevalence of catastrophe deductibles and the need to be alert to changes in homeowners insurance policies which introduce such deductibles;
    * the nature of catastrophe deductibles, what events could trigger such deductibles, and the relationship of these deductibles to availability and affordability of homeowners coverage;
    * how a percentage catastrophe deductible translates into dollar terms, and whether the consumer can afford to assume this exposure to loss;
    * possible mitigation steps homeowners can take, and how such steps could improve the availability and affordability of their homeowners coverage.

    The Panel also recommends that the CMAP Steering Committee should explore ways to encourage its participants to provide the broadest possible coverage form generally available in the industry to consumers.

- **NYPIUA deductibles**. Legislation should be enacted authorizing NYPIUA to use a catastrophe deductible program comparable to those being used in the voluntary market.

- **Hurricane/catastrophe fund**. A majority of the Panel opposes establishing a catastrophe fund. (See "Possible solutions" for the majority/minority position statements.)

TEMPORARY PANEL ON HOMEOWNERS' INSURANCE COVERAGE

Mitigation Subcommittee Report

February 1, 1998

MITIGATION SUBCOMMITTEE REPORT

The members of the Mitigation Subcommittee are:

Jim Ryman*	State Farm Ins. Co., Chairman
Jim Tuite	State Farm Ins. Co.
John Ecker*	John Ecker, Inc.
David Nadig*	Allstate Ins. Co.
Dan Robinson*	NY Central Mutual Fire Ins. Co.
Steve Wietlisbach*	Travelers Ins. Cos.
Peter Lefkin*	Fireman's Fund Ins. Cos.
Mary Lanning	ML & G Associates
Howard Honig*	Honig Insurance Agency, Inc.
Joe Calvo	NYPIUA

*Panel member

I. Purpose of the Subcommittee

A. Introduction

The purpose of this report is to define the potential application of mitigation as it relates to the mission of the Temporary Panel on Homeowners' Insurance Coverage (the Panel). The Mitigation Subcommittee recognizes that the subject of "mitigation" needs to be defined in terms that the home owning public will understand. If the issue is presented in a manner homeowners can appreciate, it is hoped they will be more likely to act on the recommendations of the Subcommittee.

While this report is intended to address the overall goal of the Temporary Panel on Homeowners' Insurance, which is making coastal property insurance available and affordable, the topic of mitigation, we believe, is much broader and should relate to the entire populace which is affected by wind, storm, surge and flooding in terms of "protecting both home and family."

B. Mitigation, a Definition

Mitigation should be stated in terms of positive value. Any action taken to "protect our homes and families" is the starting point for a definition of mitigation. Mitigation is a broader concept than simply taking precautions to anticipate or reduce loss. We would note that the project being undertaken at the State University of New York Maritime College involving the building and retrofitting of homes in coastal New York is by definition a mitigation project designed to educate and promote community awareness of the beneficial aspects of loss mitigation.

Management of the risk of loss in the event of a natural hazard by building stronger and safer homes in the coastal environment is a coastal definition of mitigation. This SUNY program has as its name the definition we propose for mitigation - "Protecting Home and Family." It suggests that mitigation protects the family, home and other possessions from the risk of future loss.

This Subcommittee believes the concept of protection should be the starting point for any mitigation project.

C. Challenge

Beyond defining mitigation in the broad sense of protecting lives and property, we need to address the current challenges for all stakeholders in any integrated mitigation project.

The primary challenge is apathy. This is typified in North Dakota's or upstate New York's failure to purchase federal flood insurance. Few homeowners, even when confronted with imminent harm, see the need to spend the dollars to protect their homes from catastrophic risk. There is a need to introduce them to the reality of the full measure of the risk and consequences they face, and to convince them of their responsibility to take action to protect themselves, their family and possessions. One way to do that is to encourage incentives which prompt mitigation activity and disincentives for not taking such action.

A practical starting point for overcoming apathy is a cost-benefit analysis showing what mitigation can provide for the individual homeowner. When this comes to life safety, the equation of life benefit is certainly skewed toward protection. At this writing, we have materials from the federal government (FEMA) and the Institute for Business and Home Safety that identify practical starting points for retrofitting homes in the area of roofs, openings, and attachments.

The alternative mitigation actions have not been prioritized in terms of their relative benefit-to-cost ratio. The insurance industry, building industry and academia are, at this time, trying to identify alternative mitigation strategies and to formulate cost-benefit standards. Applied Research Associates, Inc. from Raleigh, NC seems to be the pioneer in using the sciences of structural and wind load engineering to measure the efficacy of differing mitigation actions on individual structures. Further study of their work is needed to determine if it has potential to prioritize mitigation measures in a way that furthers the mitigation strategy we suggest for use in New York.

The Subcommittee recognizes that legislators in New York have already added an insurance credit incentive for those homes that have been retrofitted or been built with hurricane shutters and laminated glass. It must still be determined how to establish actuarially justifiable incentives or premium reductions for mitigation measures. To date, most of the rate incentives have followed the Insurance Services Office approach

that relies on product testing done by the manufacturers or on their behalf. It is the Subcommittee's belief that a better incentive result could be achieved by:

1. starting with an adequate rate level which reflects a proper evaluation of risk of future losses from hurricanes, including simulation modeling by the rate regulator;
2. using consistent benefit-to-cost analyses when prioritizing mitigation alternatives selected by a property owner or other stakeholder; and
3. reflecting the impact on the adequate rate level of the mitigation action taken through one or more of the following means: lower rate, a lower deductible option, or greater availability.

The end result to be encouraged would be an actuarially sound rate, reflective of the action taken.

Stakeholders, in addition to insurers, should be asked to consider providing their own incentives to the property owner who takes mitigation action. The incentives selected should create a package that would stimulate action by the property owner, since a rate discount or lower deductible option alone may not be a sufficient incentive.

Meeting these challenges requires addressing the perceived benefit of taking action to mitigate versus the cost of doing so. That decision is obviously impacted by the affordability and availability of windstorm insurance coverage. The affordability of such coverage will partially depend on the answers to the following insurance-related questions:

1. To what extent will mitigation efforts improve the homeowner insurance market so property insurers are more willing to bear risk or assume greater probable maximum loss in coastal areas?
2. To what extent will these mitigation efforts be translated into reduced premiums or reduced deductibles for those homeowners living in coastal areas so the cost of retrofit or new construction will be more desirable in terms of a more affordable homeowner insurance premium?

D. Why Should the Individual Property Owner Undertake Mitigation?

- Mitigation begins with an awareness that there is a potential danger to one's personal safety and that of loved ones. Such danger could also result in partial or total loss of an individual's possessions.

- Mitigation involves raising the property owner's awareness to a level that will encourage the homeowner to take action to reduce potential damages resulting from such natural threats. Action may be prompted by the homeowner:

- Realizing the life safety and health benefits of mitigation
- Avoiding the loss of irreplaceable items
- Avoiding the trauma involved when an individual/family loses their home and has extensive disruption of their lifestyle
- Reducing or eliminating issues effecting personal recovery or restoration while the commercial situations are also likely to be in turmoil
- Accepting the financial responsibility of property insurance deductibles or other cost sharing aspects of one's homeowner insurance policy
- Correlating insurance affordability directly with the loss costs so that it is reasonable to assume that through mitigation, rates would be favorably impacted
- Relating availability of insurance to the hurricane or windstorm capacity of home insurers for taking on insurance risks
- Realizing an insured can assume a higher deductible for homeowner's insurance where mitigation has taken place (or an insurer may be willing to underwrite with a lower deductible

II. History of Mitigation Efforts

A. Protection of Life and Human Resources

We have documentation of emergency preparedness for the protection of life and human resources in Long Island and coastal New York. Clearly these life safety issues are in the forefront of the federal, state, and local governments' emergency preparedness. The experience in Long Island appears to be substantially well advanced. The U.S. Government (FEMA) along with the New York State Office of Emergency Management and local communities currently have coordinated, comprehensive programs in place for coastal catastrophic emergencies. These include evacuation routes, emergency centers, and requirements for schools, day care centers, hospitals, nursing homes, and other care facilities to file their emergency preparedness plans with the state or political subdivisions. Since they are convinced that a complete evacuation of locations like Long Island would be impossible, given the limited capacity of the escape routes, they have even discussed the use of more substantial structures as safe harbors for those who cannot or will not get out of a major hurricane's destructive fury.

Training meetings are required regularly from local emergency preparedness communities, the Office of Emergency Management, and Red Cross personnel. These programs are functioning and in place. National seminars are also available for training emergency personnel. An example is a prototype plan for a Hurricane/Coastal Storm Emergency from the town of East Hampton (contact Mr. Richard McGowan at 516-324-1736 for a copy).

In contrast, mitigation efforts for property preservation in coastal New York have principally involved action by the New York Property Insurance Underwriting Association. The New York Property Insurance Underwriting Association provides some practical benchmarks for applying eligibility requirements for homeowners insurance by using required engineering inspection and retrofitting. These benchmarks require active mitigation standards by New York homeowners. In 1987, the New York Property Insurance Underwriting Association began to assess the need for mitigation as a result of Hurricane Gloria. "Gloria" was a substantial storm which struck only a glancing blow on Long Island. This near miss was a wake-up call to the New York Property Insurance Underwriting Association to establish mitigation standards in the underwriting of coastal property. Those efforts require prospective homeowners to meet minimum underwriting criteria as a consideration for eligibility for windstorm coverage.

The New York Property Insurance Underwriting Association has created "Eligibility Requirements for Windstorm Coverage." This document is available from NYPIUA (call 212-208-9700 for a copy). (Note: the New York Property Insurance Underwriting Association indicates the program of underwriting eligibility initially met with resistance from policyholders and insurance producers and community leaders. It was only after a series of educational forums sponsored by the New York Property Insurance Underwriting Association that policyholders and others began to understand the critical need for coastal home inspections and repairs to meet minimal windstorm criteria designated by architectural engineers.) Typical expenses for the improvements required by the New York Property Insurance Underwriting Association's underwriting guidelines range from $450 to $1250 dollars. Typical engineering inspection reports cost between $175 and $400 for coastal property.

The Certification Guidelines for Windstorm Coverage prepared by the New York Property Insurance Underwriting Association (also available from NYPIUA), have been tested only by the Category I ("nor'easter") Hurricane Bob which impacted coastal Long Island in 1991. No major hurricane has affected the residents of the State of New York since 1938, at which time there were significantly fewer inhabitants and property values were dramatically lower.

B. Protection of Property

From agent and insurance producer experience, we know that merchants are keenly aware of risk mitigation in the event of a disaster. In anticipation of a storm, merchants generally take necessary and prudent emergency action to protect their business

property. However, residential property owners are not as cognizant of the need to board up windows and doors, tape windows, take in outdoor furniture, etc. Most people appear unable to comprehend the true risk. Past experience indicates individuals are unwilling to take preventative steps, especially if it means spending money to avoid an unappreciated threat.

iii. Current Status of Mitigation Efforts

A. Models

The Mitigation Subcommittee finds that computer modeling of the overall assessment of risk of loss for geographic areas as small as Postal ZIP Codes is available from the hurricane simulation modelers currently used by insurers and reinsurers, including:

1. Applied Insurance Research, Inc. located in Boston, MA;
2. EQECAT, Inc., a joint venture of EQE International, Ltd. located in San Francisco, CA, and Guy Carpenter, Inc., located in New York City, NY; and
3. Risk Management Solutions, Inc., located in Menlo Park, CA.

In addition, there are other hurricane simulation models, like TOPCAT for Tillinghast, a Towers Perrin company, and CATALYST for E.W. Blanch. which have been developed, or are in the process of being developed, that will simulate likely hurricanes and their impact on the built environment.

The Federal Emergency Management Agency has already completed work on an earthquake model, HAZUS, which will provide the risk assessment for individual communities as part of their "Project Impact, Building Damage Resistant Communities," and is currently accepting bids on a similar effort for hurricanes. These efforts are in addition to research and development work ongoing in the National Hurricane Center and elsewhere to better understand and model hurricanes and their impact on society.

We find that some jurisdictions, like southeastern Florida, have recently experienced devastating hurricanes and now encourage builders to utilize mitigation measures to build stronger and safer structures which will be better able to withstand catastrophic events. The Subcommittee believes a closer review of their efforts may identify modeling and evaluation tools available for use in New York. Risk assessment or cost/benefit analysis for individual properties, communities, and the state of New York as a whole should reflect the localized risks and conditions. It should educate the various stakeholders about their risk and what can and should be done about it.

Applied Research Associates, Inc., is doing some promising work in evaluating the threat to individual structures and determining how effective alternative mitigation actions might be in conjunction with its modeling work in Florida and with the Federal Emergency Management Agency's hurricane version of the HAZUS model. Although a

thorough review and analysis of Applied Research's work is outside the scope of this report, it is the Subcommittee's suggestion that further contact with that organization be made to determine its potential to fill the need for benefit/cost information at the individual structure level in New York.

Other than the promising possibilities that Applied Research's work may hold for individual structure evaluations, the Subcommittee finds that the work completed to date by public and private sectors is relatively insufficient to adequately quantify what kinds of property loss mitigation will be most cost effective to significantly reduce loss.

B. Current Consumer Information on Mitigation

We do believe that there are some rather informative consumer guides currently available, such as, "A Homeowner's Guide to Protecting Home and Family," available from the Institute for Business and Home Safety (73 Tremont Street, Suite 510, Boston, Massachusetts 02108, Tel. No. 617-722-0200). Such easy reading how-to booklets could help consumers learn what can be done to effectively strengthen and protect their families and their possessions from loss.

The Subcommittee believes that it is critical for consumers to be made aware of their own risk of loss from natural hazards and educated on how to take effective action in protecting their families and possessions. Homeowners need to know how to get the best value for each mitigation dollar spent to make their homes more resilient.

The Mitigation Subcommittee also believes that there is a need to "model" expected losses for natural hazard events before the occurrence of a hurricane. That modeling should help both insurers and homeowners gauge the dollar exposure to loss from natural hazard events and provide an estimate of expected savings produced by different mitigation actions which could be taken. The Subcommittee believes mitigation modeling can provide greater affordability and greater availability for consumers. The pre-event mitigation modeling will also allow insurers to measure their exposure to loss and evaluate their capacity to absorb such losses and their tolerance to the resultant volatility of earnings.

By avoiding some of the market constrictions that can occur when losses from natural hazards exceed the risk tolerance of primary home insurers and reinsurers, mitigation strategies can have the following favorable impacts:

1. lower homeowner insurance premium;
2. reduce or offset windstorm or hurricane deductibles; and
3. influence (increase) overall market availability.

Mitigation strategies are the only means to effectively remove expected losses from the system. All other catastrophe exposure management schemes including reinsurance,

catastrophe-based securities, deductibles, and market limitations merely transfer risk from one stakeholder to another.

C. SUNY Maritime Project on Mitigation

The Subcommittee believes the current program at SUNY Maritime is an excellent opportunity for expansive studies in estimating mitigation alternatives and providing information derived from the study to New York consumers and others. The Subcommittee, in making its recommendations, fully recognizes that these proposals are beyond the current charge or direction of the SUNY Maritime private public partnership known as "Protecting Home and Family."

D. Building Codes - Today

Finally, the Subcommittee believes the lack of an effective New York State performance-based building code needs to be addressed legislatively. We believe that it will be difficult to quantify the dollar savings from such a building code and the enforcement of such a code. Nonetheless, a comprehensive building code and effective code enforcement is a critical component in attaining significant loss mitigation in coastal New York.

It should also be noted that because an effective building code and its enforcement will only impact new construction, an effective mitigation strategy must include action that reduces the expected losses for existing structures.

IV. Possible Solutions

A. Who Should be Involved?

The answer to the question "Who should be involved?" is easier when we consider that all stakeholders stand to win from implementing a comprehensive and strategic mitigation program. Those who have a recognizable stake in mitigation include the insured consumer, insurers, reinsurers, investors, financial institutions, local, state, and federal governments, realtors, developers, and many others. The process of mitigation will require the involvement of outside experts in fields such as natural sciences (including the scientific fields of climatology, meteorology, and geology), structural engineers, and those who can provide natural hazard simulation models to translate empirical knowledge into measurable benefit-to-cost analyses.

Principally, however, it may be the individual property owner's ultimate responsibility to take action. He/she can be encouraged to take mitigative action by the offering of incentives so that he/she will realize their own beneficial consequences of mitigation.

The logical linkage and inducement for all parties are reduction of costs, including insurance costs, and the potential benefits of greater affordability and availability of windstorm coverage and other coverage options. It is not possible for the authors of this report to reflect on any individual company's pre-mitigation rate level nor to predict potential loss savings expected from an individual property owner's mitigation action. These statistics have as yet not been quantified.

Reinsurers and investors in catastrophe bonds and other secured investment instruments should ultimately be expected to reflect the impact of mitigation action taken by property owners in their pricing of portfolios. Such actions should also result in additional capacity in the New York insurance marketplace.

Financial institutions should also consider the mitigation efforts of property owners as providing a more secure risk. To date the financial community does not differentiate between loan applicants providing loss-mitigated and non-loss-mitigated properties as collateral when evaluating the application.

The federal government continues to maintain that mitigation is a local concern because it must be encouraged at the local and state level and is the individual owner's choice whether or not to take mitigation steps on his/her property. In order for a mitigation program to succeed, it is necessary to connect the resources of the federal government with outside experts and resources. At the local and state level, there are incentives that could be created or utilized to encourage individual property owners to mitigate against future damage. These incentives include zoning, land use planning, and enforcement of a performance based building code.

It should be noted that, while the various stakeholders have some commonality of interest in mitigation, there are different factors that will motivate them to action. Likewise, individual companies within each represented industry are prone to act independently and not as an industry. This must be understood by the designers of the overall mitigation process for New York to ensure that education and awareness programs are tailored to meet the information needs of the greatest number of mitigation supporters so that the greatest level of effective mitigation is accomplished.

B. Awareness and Education

The individual property owners are not the only ones needing a fuller understanding of the risk of loss. An awareness campaign should be directed towards consumers, policymakers, legislators, government, the media, and design professionals. The campaign might begin with proactive programs in elementary and secondary schools explaining the dangers presented by windstorms and the need for mitigation and loss reduction to protect lives and property.

This education effort could include public service announcements and the distribution of brochures currently available through entities such as FEMA and the Institute for Business and Home Safety. Public/private partnerships of organizations and governmental agencies coming together with a goal to support mitigation should be encouraged.

It is the Subcommittee's recommendation that we initiate a broad awareness campaign through public/private partnerships which will highlight the need for mitigation. A prototype of such a program is found in the partnership of the Institute for Business and Home Safety and the federal government's Subcommittee for Natural Disaster Reduction, which is called Public Private Partnership 2000, (PPP2000). Local examples include the SUNY Maritime "Protecting Home and Family" program and The New York State "Joint Loss Reduction Partnership Project."

C. Mitigating Loss Exposure

In proceeding with any mitigation program, a question that needs to be raised is, "What can be done to mitigate loss exposure?"

Land Use Planning

Land Use Planning is a critical step in mitigation for future construction. In reality there is little land use planning opportunity in the densely populated areas of Long Island, including Nassau, Suffolk, and Queens. Any land use planning currently in existence is derived from the Federal Flood Insurance Program and the various maps designating flood hazard areas. We will not provide extensive comments on the flood susceptible areas and the designated flood plains, although there is extensive research that has been done by FEMA and the National Hurricane Center on flooding from the storm surge that accompanies hurricanes. The theory behind federal land use planning has been to discourage building in high risk zones by not offering federal flood insurance.

New York also has the coastal barrier zones created by the Coastal Barrier Improvement Acts of 1982 and 1990. Moreover, New York State has an Environmental Conservation Law at Article 34 and implementing regulations that require that no new construction be undertaken in coastal erosion hazard areas. The regulations also limit reconstruction, alteration or improvement within the variance zone if property is totaled by a storm. In point of fact, the land use planning aspect of mitigation would only be practical <u>after</u> the catastrophic loss event.

Building Codes - Cost Benefits

The second recommendation to accomplish mitigation is enacting and enforcing building codes. While a building code cost analysis is addressed later in this report in the section entitled, "Modeling and Mitigation," we would reference a paper presented

by Howard Kunsreuther of the Wharton School, "Managing Catastrophic Risks Through Insurance and Mitigation." The paper addresses research methodology "for assessing the role insurance and other policy tools can play in encouraging property owners to take steps to reduce loss from natural hazards. ...Experimental data suggests that property owners are reluctant to incur the up-front costs of risk mitigation measures..."

At this time, New York State lacks a comprehensive performance-based statewide building code. Building codes exist, but they tend to be prescriptive. Present building codes are neither dynamic nor responsive to functional or design needs. Hence, properties with unique architecture and engineering standards are not required to meet dynamic wind resistance standards, e.g. withstanding a wind load of 150 m.p.h. At a minimum, New York should adopt a performance-based building code such as that known as BOCA, commonly adopted in most of the Middle Atlantic states.

This is not to say that the BOCA code has specifically adapted to the windstorm exposure by requiring anchoring or shuttering. However, it would be a baseline standard for new construction or reconstruction. The BOCA standards allow retrofitting and remodeling to be judged in terms of wind resistance performance.

In the final analysis, the homeowner needs practical advice on constructing a new home or retrofitting an existing property to make it stronger and safer from hurricane winds. Another publication by the Institute for Business and Home Safety entitled, "Is Your Home Protected From Hurricane Disaster," is an example of what a homeowner can use, as an interim step until better information and analysis can be accomplished as to the efficacy of different mitigation alternatives, to provide some practical precautions which result in minimizing the home's exposure to wind loss. The pamphlet discusses engineering systems that withstand wind loss, and the brochure discusses the roof, points of wind entry, windows, doors, and garages, and the anchoring of roofs to the home and the home to the foundation. The report also provides practical guidance for home inspections.

As previously noted, mitigation measures have not been prioritized based on cost/benefit analysis. The scientific and the insurance and business communities are in the process of trying to quantify what strategies of retrofit and construction will provide the most effective dollar benefit. These efforts should be encouraged by every person with an interest in mitigation activities. Such efforts are necessary to gain facts that would replace judgment necessarily relied upon today in determining what mitigation steps to take. It is to be noted in authoring this report that cost-benefit prioritization of fixes is a particularly critical step that must be accomplished as an incentive for homeowners to begin taking mitigation precautions. Prioritization provides a rational basis for property owners to undertake mitigative steps and for other stakeholders to offer incentives to encourage the owner to take such steps.

Modeling and Mitigation

There are two different sets of models to be discussed that would affect mitigation for the purposes of this report:

1. **simulation modeling** of hurricanes and the expected loss impact for different portfolios of insured structures in the current built environment; and
2. **"what if?" modeling** of the impact on an individual structure for different substantive mitigation actions that could be taken with output that consistently measures the benefit to the various stakeholders and the cost to the individual property owner.

These models are described below:

1. Simulation Models

There are a number of sophisticated simulation models available today from companies like Applied Insurance Research, Inc., EQECAT, Inc., and Risk Management Solutions, Inc., that are already in use by insurers, reinsurers, capital markets, rating agencies like A.M. Best, and others to assess the risk of loss for large blocks of their insured risks. Their focus is on the identification of expected future hurricane losses for ratemaking and catastrophe exposure management purposes.

In order to gain an appreciation for the input, the general internal workings, and the output of these models, we will attempt to generalize how they go about yielding expected future hurricane losses.

Input data and Information

The following represent the kinds of data and information used by most modelers if it is available.

a) Historical data on the known hurricanes from the historical record, including any information on such components as the air pressure or strength of the storm, the size of the eye wall, the shape of the storm and the radius of maximum winds, the wind speeds generated in the affected areas, the landfall location, the forward speed and direction at landfall.
b) Meteorological expertise that helps define different components in any given hurricane and the resultant impact to various segments of the coastline and the interior. These data will be used to simulate the hurricanes that are likely for possible locations of landfall.
c) Wind engineering expertise that can be used to simulate the resulting wind fields generated for simulated likely events.
d) Coastline definition.

e) Type of man-made and natural terrain over which any hurricane would necessarily have to traverse and the terrain's impact on the storm's energy and winds.
f) Structural engineering expertise to calculate the likely vulnerability to the wind loads generated by the simulated storms of differently constructed structures.
g) Information on the built environment, usually including the number of risks, their value, the structure's age, a description of types of construction and number of stories, and geographic location from an individual insurer's book of business. Sometimes this data may be extracted from the modeling company's proprietary data bases that include data on structures and their value derived from a variety of government or private data bases.
h) Coverage provided under the policy for structures, the contents, and the time-related coverage for additional living expense or business interruption expense, any deductibles and limits that may apply.
i) Historical hurricane claims histories from insurer and reinsurer clients to calibrate their theoretical damage curves.
j) Visits to disaster sites (or studies done by experts who have visited such sites) to get data to check expected components of the model against actual events.

Hurricane Simulation

This, the most guarded and proprietary section of the models, has received considerable scrutiny by the Florida Commission on Hurricane Loss Projection Methodology and its professional team of experts during on-site visits to each of the major modelers to delve into the internal details of the models. To date, three models have been certified by that commission: Applied Insurance Research, Inc.; EQECAT, Inc.; and Risk Management Solutions, Inc.

Individual insurers and reinsurers have also scrutinized these models in considerable detail as well. At least one major insurer has sponsored modeling symposiums for groups of regulators to let them meet the modelers, see how their respective models were built, ask whatever questions were important to them, and increase their level of comfort in those models. Such continuing dialogues are to be encouraged, especially between New York State regulators and the modelers.

This portion of the models yield both the frequency and severity information on each modeled storm. For each storm simulated, the following types of information are generated from the simulation:

a) energy level of the storm, either based on air pressure or maximum wind speeds at the eye wall;
b) radius of maximum winds, denoting the diameter of the eye wall for the storm;

c) the size and shape of the storm, both at landfall and as it leaves its footprint across the landscape;
d) the landfall location, the forward speed and its direction at landfall, which will affect its simulated track over land; and
e) the frictional effects of natural and man-made terrain.

In the case of a Monte Carlo simulation, all storms are simulated for an assumed number of simulations, say 100,000 possible storm scenarios for any given year; whereas those modelers using stratified random sampling techniques will run a smaller number of simulations and associate the relative probability of such a storm with it.

Estimating the vulnerability, or damageability, for structural types and ages

a) For each geographic location and for each simulated hurricane, vulnerability of the modeled structural types and ages of structure is simulated based on the simulated wind speed at that location.
b) "Ground up" damage (assuming no deductible or limits on insurance coverage) is calculated for that structure in the model.

Output from the models

The modelers determine the aggregated insured portions of the losses from the simulated storms for their clients based on the insured portfolio, the coverage limitations and deductibles for the respective insured properties, and what level of expected loss detail is required for the particular intended usage of the data.

a) Based on the limit of coverage and deductible carried on the policy, an insured portion of the damage is determined for each policy or groupings of policies supplied by the insurer.
b) For reporting back to the insurer or reinsurer, the modeler would accumulate the simulated losses for the insured book of business into report detail required under their contract, which would likely include:

    1) accumulated losses for all simulated hurricanes by ZIP Code or other geographic grouping for territorial rate making use;
    2) accumulated losses for the "tail" of the distribution for catastrophe exposure management use, with the "tail" being defined like that required for reporting to the A.M. Best and other rating agencies in terms of events equal or larger than that with a 1/100 or 1/250 frequency of occurrence, which data are also used by management to measure against their benchmark for tolerance for risk of loss of capital or for a certain level of acceptability of variability of expected annual earnings; and
    3) for the reinsurer, there is an interest in the expected losses in the book, the ceded layer, and for the time period of the contract with their reinsured company.

2. "What if?" Models

A second model is necessary to make the full leap from expected losses for an insured portfolio of risks to identification of the expected losses for an individual structure. Without accounting for the effects of mitigation, models assume classes of structures behave the same when subjected to different wind loads from the simulated hurricanes. In order to appropriately measure mitigation alternatives for an individual structure, modeling of the structure's expected damage due to the wind loads for each simulated hurricane must be done to get the appropriate benchmark against which to measure the impact of alternative mitigation action scenarios. The structural engineering underpinning for this type of model requires more structure details than simulation models that are used primarily for portfolio analysis.

Applied Research Associates, Inc., of Raleigh, NC, claims its modeling program can make use of an on-site engineering inspection of a structure to run "what-if" analyses that vary the mitigation action for an individual structure and then measure the respective benefit-to-cost ratio for such action. Its model incorporates the following components:

a) Facility Selection - specific structures are selected for an on-site inspection and the simulation model.
b) Building-Site Audit Data Collection - data on the specific structural components of the structure are collected.
c) Site-Specific Hurricane Hazard Risks - simulations are run to identify the wind loads and missiles to which the structure would be subjected.
d) Vulnerability-Loss Analysis for Each Building - vulnerability of the individual structure to the wind loads, tree blow-down risks, and missiles are determined and the expected losses identified for ratemaking and catastrophe exposure management purposes.
e) Outputs of the Model -
   1) Hurricane Hazard Risk
   2) Building-Site Audit Report
   3) Facility Vulnerabilities - to direct wind action and wind-borne debris/missiles, identifying failures of roof components, of window and door openings, of wall components, of structural frame and roof/wall connections, and of foundations
   4) Mitigation Analysis and Cost Effectiveness - the capability to handle optimal design, mitigation "what-if?" analysis, and benefit-cost analysis is of greater relative interest
   5) Integrated Protection/Preparedness Plan
   6) Insurance and Deductible Analysis

V. Findings and Recommendations

A. Findings

The Mitigation Subcommittee concludes that any solution must be of value to all the parties impacted. That value should be a direct benefit to the insured and the homeowner. Other stakeholders will benefit indirectly.

At this time, the Mitigation Subcommittee urges that a comprehensive and coordinated mitigation plan be developed and implemented in New York with the following additional resources being identified as integral to successful mitigation of expected future losses:

1. Modeling to assess and define what mitigation strategy(s) will work to promote homeowner insurance availability and affordability.
2. Summarizing the various building materials, products, and engineering reports which have proven to provide additional home safety/security.
3. Using the fundamental principles outlined in FEMA's Project Impact-Building Disaster Resistant Communities mitigation program as a consideration for any New York mitigation program:

   a) Communities must build a partnership among all elements of the community that can work together towards the common goal of saving lives and protecting property.
   b) Communities must undertake a program of risk identification so they clearly know the magnitude and types of threats they face.
   c) Communities must identify what they are going to do to mitigate against and prepare for these threats and lay out a program to address these issues.
   d) Communities must get support to initiate these programs from all segments of their population, including the business community.

U.S. Government (FEMA) mitigation materials reviewed should be distributed to residential coastal and other hurricane-exposed homeowners in New York as well as to lending institutions, realtors, builders, etc. (*Note*: The Web site for FEMA is located at **http://www.fema.gov**.)

1. One recommended publication is entitled, "National Mitigation Strategy: Partnerships for Building Safer Communities."
2. A second recommended publication entitled "Report on Costs and Benefits of Natural Hazard Mitigation" (published March 1997).

We believe the subject of mitigation addresses the need to protect home and family against catastrophic exposure of windstorm in the most fundamental sense by providing individuals with the means to protect property and lives. While land use planning is not

a practical answer to most of coastal New York and Long Island, it is certainly a topic that cannot be ignored. We have found that communities of Long Island have functioning emergency preparedness plans. We have found there is experience in the role of certification and inspection and eligibility for windstorm coverage through the past experience of the New York Property Insurance Underwriting Association. We have not been able to assess dollar values of mitigation on homeowner policy deductibles, CAT premiums, and the overall affordability of homeowner insurance. We can intuitively suggest that in every instance the result of an effective mitigation strategy would be beneficial to the consumer and all stakeholders.

It is critical in a coastal market with risk transferred through deductibles to homeowners that the public and private sector allow for programs of mitigation which can reduce the risk borne by homeowners.

B. Recommendations

- **Building Codes** A critical recommendation of the Panel is adopting and enforcing performance-based building codes and uniform building codes throughout coastal New York and New York State. Enforcement at the local level is essential.

- **Effective Mitigation Incentives** There is a need for a range of public and private incentives to encourage homeowners (of existing homes) and home builders and buyers of new homes to retrofit or purchase homes which offer protection against the exposure of hurricane and high wind loss as well as other exposures related to living in coastal areas.

    - Public sector solutions should include tax incentives for mitigation of loss. These should include exemption from real estate tax assessments on improvements and real estate tax reductions to reflect the value of mitigation, sales tax incentives for approved or certified retrofitting of existing homes, and income tax credits for purchasing or retrofitting existing homes.
    - Requiring a certain wind resistant performance standard before coverage would be available in the New York Property Insurance Underwriting Association remains a public incentive for mitigation that could be transferred to private sector insurance in terms of encouraging underwriting along the coast or underwriting with varying market deductibles or premium credits.
    - An economic strategy should be put into effect by insurers to ensure that mitigation is a reasonable and economical choice for the coastal homeowner, buyer, or builder.

- **Coordination at the State Level** Government activities in the area of mitigation should be coordinated, along with the mitigation resources of insurers, financial institutions and the private sector (e.g., home building suppliers selling materials and products to retrofit existing homes).

- **Research and Development**

  - Access to and support of research and development of building products and techniques should be encouraged.
  - A consistent means to evaluate the beneficial impact of mitigation actions and their cost to the consumer needs to be implemented.
  - Development of cost-effective and damage reducing building products and techniques for new construction and retrofitting to existing structures should be tailored to the specific risk's characteristics.
  - A standard means of measurement using computer modeling and expert opinion can determine risk of loss for the individual property and for the community as a whole and the cost/benefit of taking mitigation actions.

- **Awareness** All the stakeholders, beginning with the property owner, need to be made aware of the risk of loss for each location and what can be done to lessen it. Public awareness campaigns to convince property owners that mitigation is the right thing to protect their families, their possessions, and their community can be developed. Pamphlets and other materials should be produced to describe the risk, including a general assessment for the individual and for the community in which they live.

- **Education** In addition to building an awareness of the threat, there is a need for all the stakeholders to know where and how to build structures, given the risk of loss from likely natural hazards. Understanding the reasons for mitigating and the impact of taking action are important parts of the education process.

  - Education should be targeted to the stakeholders, consumers and their children, builders and inspectors, insurers and reinsurers, and regulators and others sworn to uphold the public's trust.
  - Educational material could include "how-to" guides on where to build and how to build new or strengthen existing structures to withstand loss.
  - Educational efforts could also be directed to the benefits and costs of taking alternative mitigation actions, the various methods of financing mitigation action, identifying intangible benefits of mitigation to the owner and occupants, and mitigation's impact on availability and affordability of homeowner insurance in hurricane-exposed regions.

TEMPORARY PANEL ON HOMEOWNERS' INSURANCE COVERAGE

Capital Markets Subcommittee Report

February 1, 1998

CAPITAL MARKETS SUBCOMMITTEE REPORT

The members of the Capital Markets Subcommittee are:

John Cashin	Willis Faber North American, Inc.
John Freedman	USAA
Marsha Cohen	Reinsurance Association of America
Mary Lanning	ML & G Associates
Steve Wietlisbach	Travelers Insurance Company
Ross Davidson	USAA

I. What is a Capital Markets Solution?

Traditionally, the insurance markets (primary insurers and reinsurers) have provided financial capacity through contractual obligations to pay policyholder claims and claim adjustment expenses related to catastrophic events. Providers of capital for such capacity have included investors in common and preferred equity instruments issued by insurers, and "investors" who dedicate capital to support reinsurance contracts entered into directly or through brokers or various insurance exchanges. Risk diversification has been accomplished through various pooling arrangements among insurers, reinsurers and direct investors which allow spreading of risk concentrations so that no one insurer need be overly exposed to a single risk or group of risks. Nonetheless, however effective in spreading risk and improving the use of insurance capital, these pooling arrangements still rely on the capital available from traditional insurance sources.

Insurance has long been thought of as a specialized area of investment reserved for insurance professionals. The gulf between investors who were comfortable with insurance risk and those inclined to the more straightforward fixed-income and equity markets was wide and infrequently bridged. Catastrophe exposures have increased dramatically over the past decade raising concerns that additional capital beyond that available from traditional insurance sources is needed to effectively deal with mega-events. Fortunately, over the past two decades, several developments laid the groundwork to narrow the gap between the insurance and traditional capital markets. This has resulted in traditional debt and equity investors being more amenable to committing a portion of their portfolios to direct coverage of catastrophe exposures. These developments include:

- Principles of mathematics, statistics and finance have merged to develop techniques to measure risk and to structure optimal risk-adjusted return "portfolios" of assets and liabilities with dissimilar or complementary risk profiles.

- The application to financial securities of traditional risk management instruments and techniques used for centuries in the commodities and currency markets gave rise to modern financial engineering. Financial engineering allows any economic interest to be dissected into discrete elements and regroups the resulting pieces to form new instruments that fit particular investment characteristics to an investor's unique need.

- The ensuing ability to measure and price options, futures and swaps imbedded in financial securities has also played a major role in this financial market evolution.

- The scientific measurement and documentation of the dimensions of natural disasters and the accumulation of large volumes and time series of related information regarding natural disasters has made possible the simulation of loss experience in various natural disaster scenarios.

- The advent of more powerful computers has allowed the development of more sophisticated simulation software for modeling natural disaster exposures on a grand scale. This allows investors to step above individual events and gauge the return and risk characteristics of classes of financial assets and liabilities as they apply to funding natural disaster exposures.

- Techniques have been developed to measure and categorize economic interests with similar risk characteristics, and package the rights to the cash flows related to those interests into standardized financial instruments that can be traded. Notable examples are mortgage backed securities, various derivative securities and other asset backed securities.

- Independent rating agencies, market makers, sellers and buyers of securities have acquired these skills so that all elements of a viable market are aligned.

Using these techniques, any contract or group of contracts that convey economic benefit or incur economic obligation (such as insurance contracts) can be quantified and dealt with in fundamental, common terms. Further, the risk, or the variability or uncertainty of future economic performance, can be quantified and managed, regardless of the source of that risk.

Insurance regulators have begun to acquire the above-mentioned skills and are beginning to recognize and accommodate financially engineered instruments used to manage catastrophe exposures in the laws and regulations that govern insurance solvency and investment.

A. Current Approaches to Capital Markets Support of Insurance Risks

Capital market approaches to funding catastrophe exposure vary broadly and are described by many terms that are proprietary and unique to their inventors. However, they each have fundamental characteristics by which they can be described and evaluated. These include:

- function (risk transfer or financing);
- timing (pre- or post-event funding);
- the market segment providing capital (investment, insurance);
- the manner in which the covered risk is measured (index, indemnification);
- the legal structure (security, private placement or insurance contract); and
- the manner of offering, distribution or sale of the securities (private or public).

These characteristics, along with various "deal" features can be combined in unlimited ways to produce a variety of catastrophe funding instruments. Basic categories of capital markets catastrophe funding instruments are described below. Each may be structured differently to meet the varied needs of the cedant, investors, and regulators.

1. **Liquidity Facility**: These instruments provide cash to pay claims and expenses related to catastrophes. By their nature, they are a form of financing, to be repaid within a defined period with interest. These facilities may or may not be secured, but generally they rely on the creditworthiness of the borrower for repayment. Commercial banks typically provide such facilities. They may be committed (with dedicated capital backup—for a fee) or uncommitted (as available) facilities. Funds are distributed upon specified occurrences, which may include the nature and magnitude of the event and whether a material adverse change (MAC) has occurred to the party obligated to repay.

2. **Securitization**: In general, this is a method of combining ownership of assets or rights to economic value from individual contracts into an investment contract. The underlying asset or contractual right is the source and collateral for repayment. As such, the economic risks and rewards of ownership flow though to the ultimate investor in the security. Assets or contracts are typically held in trust for the benefit of investors and cashflow therefrom is disbursed under contractual terms for payment of investment obligations.

   A typical structure used to apply principles of securitization to the funding of catastrophe exposure includes granting to investors certain rights to cashflow (premiums) from a reinsurance contract between one or more primary insurers and a special purpose reinsurance company (SPRC). This SPRC is formed for the sole purpose of reinsuring the exposure to be funded by capital provided by traditional capital markets investors. Investors purchase securities from this SPRC, the proceeds from which are held in trust and invested in high-grade

securities. The funds held in trust may be released to cover costs related to catastrophes per the terms of the reinsurance contract. To the extent not used under the terms of the reinsurance contract, funds may be used to pay obligations to investors. Interest from the assets held in trust and premiums from the reinsurance contract are sufficient to provide a return to the investors in the SPRC for the repayment risk assumed in the transaction. Through financial re-engineering, rights to the cashflows from the reinsurance contract and the interest from assets held in trust may be stratified and prioritized such that the terms of some of the securities include a full contractual obligation to repay principal and interest and other securities may carry only a contingent obligation. Based on current U.S. tax law, the economics of these transactions require that the SPRC be incorporated and operate in a non-U.S., tax-advantaged jurisdiction.

Nationally recognized credit rating agencies have begun to evaluate the risks attendant to some of these structures and have awarded investment or non-investment grade debt ratings to the related securities. With some few exceptions, state insurance regulators generally view the securities related to these structures as investments and not as insurance contracts. The NAIC recently decided to award risk-based capital bond classification status to such securities that receive a fixed-income rating from a Nationally Recognized Statistical Rating Organization (NRSRO). This will cause investments of this sort to be more attractive to insurers because they will have to hold less capital to support them.

3. **Options, Futures and Swaps**: These structures, generally known as derivatives and used for centuries in the commodities, insurance and currency markets, have been increasingly applied to financial instruments of various forms over the past two decades.

   - **An "option"** is the right to acquire from, or transfer to, another party economic control of an asset or obligation upon the occurrence of some future event. Catastrophe options can be traded directly (e.g. catastrophe options traded on the Chicago Board of Trade) or they can be integrated into other instruments (e.g. a contingent surplus note includes a put option that is exercised only upon the happening of a specified event). Options to fund catastrophe risk may operate with reference to indexes of loss or can be based on the loss experience of an individual insurer or reinsurer.

   - **A "future"** is the right to acquire an asset or assume an obligation or stream of cashflows at stated values at some future date. Futures are implicit in various forms of pre-funding of catastrophe exposures. For example, the agreement of a SPRC to fund a stated percentage of an insurer's losses upon the occurrence of a catastrophe is a form of future. Futures contracts

can also be traded based upon a catastrophe index allowing for hedging of future risks.

- **A "swap"** is an agreement to exchange one basis of value of, or income from, an asset or obligation for a different basis related to another asset or obligation. As applied to funding catastrophe exposures, swaps can be used to exchange the value of one regional catastrophe index for the value of another regional catastrophe index, thus allowing for diversification of risk without having to enter into the underlying insurance contracts directly.

4. **Surplus and Capital Notes:** These are special forms of debt instruments which, due to restrictions on their repayment terms are accorded certain degrees of equity treatment for insurance solvency regulation purposes. The rules governing these instruments are included in state insurance law and regulations which generally conform to model laws, risk-based capital formulae and accounting treatment adopted by the National Association of Insurance Commissioners. To qualify as a Surplus Note or a Capital Note, debt instruments must meet certain criteria as to maturity, amount outstanding and the financial condition of the issuing insurer. Repayment of principal and interest on Surplus Notes requires advance approval, subject to specified criteria, of the chief insurance regulatory official of the state in which the insurer is domiciled. Capital Notes do not require advance regulator approval for payments of principal and interest as long as certain conditions are maintained.

   Qualifying Surplus Notes are listed in the insurer's capital account and are deemed as Surplus for various regulatory solvency ratios, including minimum legal capital calculations. Qualifying Capital Notes are listed as debt on the insurer's balance sheet, but are added to surplus in determination of an insurer's risk-based capital calculation for minimum regulatory capital purposes.
   Issuance of Surplus Notes is commonly provided for under many state laws. The regulatory parameters governing the issuance of Capital Notes have only recently been adopted by the NAIC. Enabling legislation or regulations may be required to allow issuance of Capital Notes in a particular state.

   These instruments can be issued by an insurer in advance of a catastrophe to pre-fund exposures or an insurer can enter an agreement to issue these instruments on a contingent funding basis as a post event funding mechanism. In either case they represent important tools for accessing the capital markets for catastrophe exposure funding.

5. **Non-Traditional, Expanded Reinsurance:** Variations on traditional forms of reinsurance have emerged in response to the need for insurers to meet regulatory requirements, qualify for favorable accounting treatment and attract additional investors to fund catastrophe exposures. To the extent that these

variations actually expand existing or attract new sources of capital to funding catastrophe exposures or facilitate more efficient deployment of existing capital they may also be viewed as capital market solutions.

Using the above techniques and instruments, cedants and investors now enjoy a continuum of opportunities to access and employ investment capital. Capital can be accessed by cedants and employed by investors on a contingent, debt capital, equity capital and pure risk basis, with gradations between each of these points on the continuum to allow specific tailoring of transactions to unique needs. Investors and cedants have become very sophisticated in the structuring of portfolios of assets and exposures with various complementary risk characteristics. Cedants have become comfortable with capital markets instruments and investors have begun to accept natural disaster catastrophe-linked securities as a valuable part of their portfolios.

B. Sources of Capital

Introduction/Background

Traditionally, insurers providing personal lines coverage in New York State have relied on a combination of their own financial resources and/or the resources of the international reinsurance market to absorb potential hurricane losses. The $16 billion in insured loss caused by Hurricane Andrew provided a wake up call to insurers nationwide. The mounting insurance exposures due to sustained coastal development and rising real estate values drove potential losses beyond the capacity of traditional insurance and reinsurance markets to absorb.

New York State's coastal exposures have been steadily increasing over 60 years since the 1938 hurricane. Losses from the potential one-in-86-year storm would be in excess of New York premium, i.e., loss of $3.6 billion. It would take 86 years to recover at a constant premium level. Alternatives are: 1. raise rates; 2. buy reinsurance to reduce the retained loss; 3. develop new capital markets products; 4. continue present trend to develop new multi-year financial products with reinsurance and capital markets features. With total U.S. insurance capacity of an estimated $268 billion, the insurance industry has begun to look to the U.S. capital markets for alternative capacity. Insurance securitization offers insurers access to the estimated $17 trillion in capital markets capacity as a supplement or alternative to traditional capacity for risk transfer.

The Range of Risk Capital Sources

The general investment capital markets are the main source for capital markets insurance products. Catastrophe insurance exposures primarily are securitized by the approximately $300 billion of insurance company stockholders' surplus. The capital markets initiative proposes that a portion of the catastrophe market exposures - those with the lowest likelihood of loss at least - can be securitized by the $16 trillion of the general investment capital markets. The initiative is to supplement the insurance

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securitization for low frequency, high severity events.

The investment capital markets themselves are segmented. All segments of the markets have been facing the problem of finding a sufficient supply of investment vehicles to service the yield requirements of their capital. Some of the investors are willing to look outside of traditional vehicles to find new avenues of investment. They are willing to trade off higher yield not only for higher risk, but also for innovation risk - particularly for non-correlative investments. Catastrophe insurance capital markets instruments provide attractive investment opportunities to this segment of the general investment capital markets. This segment sees appropriately rated instruments with attractive yields and zero beta correlation.

The insurance entities placing these instruments are securing long term strategic price and capacity stability.

C. Benefits to Cedants

Expansion of capital markets funding alternatives for catastrophe exposures has proceeded rapidly, as investors have become more comfortable with assessing the catastrophe risk of particular cedants. At the same time cedants have developed the ability to assess the benefits and preferred structural characteristics of alternative funding proposals. The benefits to cedants can be categorized into the following broad groups. These benefits may be present to a greater or lesser degree, or may not pertain at all to a specific structure, depending on the terms and conditions of the particular deal.

1. **Diversification of Sources:** Additional sources of risk capital have been generated by these transactions over and above the traditional sources of insurance risk capital. This benefits cedants by providing greater stability of funding sources and greater security that cedant programs can continue through strong and weak markets.

2. **Reduction or Elimination of Credit Risk:** Several of the above structures are designed to be bankruptcy remote or, due to their pre-funding of capital at risk, are not subject to credit risk at all. Accordingly, the funds to pay for claims will be available regardless of the financial condition of the original investor or the cedant, thus eliminating payment or credit risk inherent in traditional post funded transactions.

3. **Additional Capacity:** The ability of cedants to attract other risk capital to support catastrophe exposures frees up existing capital to support additional business. Depending on the cost of the new capital and the ability of the cedant to recover that cost in the rates charged for coverage, this can increase the appetite or capacity of the cedant to write more business, including business in catastrophe prone areas.

4. **Multi-Year Coverage:** Traditional insurance and reinsurance contracts tend to be single year. On the other hand, traditional capital markets instruments have maturities ranging from days to decades. As capital markets become more amenable to funding natural disaster exposures, multi-year contracts will become more common. This will reduce costs and complexity to cedants of issuing these instruments and will allow greater flexibility and stability in structuring catastrophe management funding programs. The availability of multi-year funding may in time influence development of longer-term coverages that could further stabilize the market.

5. **Clean and Definable Trigger:** Capital market investors require relatively simple terms. The conditions under which funds are released from the trust in a securitized transaction must be clearly defined to minimize confusion and differences in interpretation. This could reduce contract disputes and related legal uncertainty and administrative delays.

6. **Prompt Claims Payment:** Traditional insurance arrangements can experience administrative and legal delays in payment, which could result in defaults that can impact the rest of the market. These structures tend to be less subject to interpretation and delay. As such, cedants are paid more quickly.

7. **Stable, Transparent Pricing:** Traditional capital markets tend towards being efficient. This results from the fact that securities and derivatives markets are characterized by relatively standardized contracts, with broad participation and are very competitive in their pricing. As the capital markets evolve in their ability to assess natural disaster exposures, they will tend to eliminate information barriers to entry and resolve irrational pricing. Rating agencies assist in this process by evaluating the investment and claims paying risks associated with various structures, thus allowing for more consistent, efficient and stable pricing of risks. Cedants will benefit over traditional insurance markets from this more open and competitive environment for risk capital.

D. Benefits to Policyholders

Policyholders of primary insurers benefit from capital markets funding of exposures to the extent that additional capacity and efficient pricing translate into:

1. improved availability and affordability of catastrophe insurance,
2. greater solvency of the insurer, and
3. enhanced stability of the market for primary insurance.

The willingness and continuing ability of primary insurers to provide catastrophe insurance, and, therefore, the ability of policyholders to obtain and afford such coverage, can be enhanced if these market efficiencies can be transferred to the policyholder. This presumes that pricing of capital markets instruments will be seen as

acceptable to regulators in the rate making process. If insurers are required to bear a portion of such costs and are not able to pass them to policyholders in pricing, availability will not be improved. Solvency of insurers will be enhanced to the extent that capital markets can truly bear some of the risks that are currently wholly borne by the insurance industry's capital base. Insurers will also tend to be more solvent due to the transparency of pricing of the risk capital employed to cover catastrophic exposures. This should force more consistent, rational pricing of such risks, to the extent the regulatory process allows. Diversification of capital funding sources, multi-year coverages, and more stable and rational pricing should work to stabilize the market for primary catastrophic coverage, which will directly benefit policyholders.

E. Benefits to Regulators

Regulators represent the interests of policyholders. As such, they focus on the often-conflicting goals of affordability and availability of insurance and the solvency of insurers. Thus the benefits ascribed to cedants and policyholders will also accrue to regulators. Concern about the solvency of insurers should make the risk-transfer features of capital markets solutions and the additional source of risk capital offered thereby especially interesting to regulators. Regulators may also benefit from the efficient pricing of natural disaster exposures in their ratemaking processes. Over time, capital markets tend to price risks rather dispassionately and efficiently. Such an impartial pricing mechanism can provide and additional benchmark for rates for catastrophe coverages.

F. Reasons for Investment

Capital markets investors are attracted by the yield/value, portfolio diversification benefits and liquidity of catastrophe funding instruments. Although individual deals may be structured as risk transfers, capital markets participants will require portfolios of insurance risk to yield a fair return on, and eventual return of, capital over the long run. Investment practice has evolved from an individual transaction orientation to a long-term, risk-adjusted, portfolio yield orientation over the past two decades. Risk profiles of catastrophe-linked securities are generally perceived as not being correlated to risk profiles of more traditional capital markets investments. As such, they provide important diversification benefits when combined in a broadly diversified portfolio of fixed income and other equity investments. In addition, as more capital markets deals are done, the ability to diversify portfolios of natural disaster exposures across a broad range of geographies, perils and structures will allow greater diversification within this asset class. Investors are also interested in the liquidity of their investments. The liquidity of the market for catastrophe linked securities will develop as more transactions of size are completed and Wall Street firms begin making a secondary market in these securities.

G. Investment Criteria

For the instruments to be attractive to investors they must meet four criteria:

- Adequate reward
- Low risk
- Fungibility
- Low correlation to other investment vehicles.

The underlying assessment of the physical risk has been the key to establishing the risk reward character of these instruments. In the example of the USAA bond offering, analysis of hurricane probabilities conducted by Applied Insurance Research (AIR) showed that the probability of loss was less than 1%. This research was reviewed by the rating agencies, which applied it in turn from a credit rating perspective - i.e. they used the AIR evaluation to underpin their assessment of the likelihood of the bonds to perform for investors. In this context, the USAA bond offering itself was engineerad to respond to differing investors' appetites. It was split into two parts: a tranche that was substantially at risk and was rated accordingly (Moody's Ba2), and a tranche whose return was virtually guaranteed (Moody's Aaa), with returns that reflected the relative risks.

Catastrophe bond instruments at present are not highly fungible - in large part because of the paucity of supply. The USAA placement - and others - has shown an increasing appetite on the part of investors. The yields on the USAA instruments are somewhat higher than those of other instruments which are technically similar - as well as being somewhat more expensive than the cost of traditional reinsurance - in part because of their low fungibility at present. Please note that mortgage-backed securities underwent a similar transition after they were introduced to the markets in the 1970's. It took nearly a decade for the market to develop - both from a supply and investment perspective - and become liquid.

The structure of the transactions placed to date has been key to their acceptance by the rating agencies and by the capital markets. Generally speaking, they have been structured to compartmentalize the deals into low risk, lower return portions and high risk, high return portions. The high risk elements are first to respond to loss and are exposed in some cases to loss of principal. The lower risk elements usually hold the portion of capital that provides investment flow for the transaction and are subject to investment rate return risk.

H. Legal Impediments

As promising as securitization of insurance risk has been in accessing the capital markets for catastrophe exposures, there are significant unresolved legal barriers to expanding this market and making it generally available to insurers. Existing federal tax and insurance regulatory issues (discussed below) require complex structures to make

these transactions economic. This has retarded the proliferation of an otherwise promising market. As a result, many securitization transactions are private, highly structured and involve only a few sophisticated investors. Recent large transactions, which have been structured to successfully navigate a path through complicated state regulatory issues and have avoided federal tax issues, are encouraging exceptions to this pattern. Legal and regulatory processes have begun to address these issues, but significant barriers and uncertainties remain.

In the capital markets, investors tend to shy away from very complicated structures. At a minimum, they charge a premium for doing a complicated deal because the risks are so difficult to assess. In addition, the number of sophisticated investors who have the resources to undertake such transactions and the underlying risks they fund is very limited. Complicating these transactions further is the specialized legal and tax advice needed to structure these deals. All of these factors add to the cost and reduce the potential success of any particular transaction. If federal tax and state regulatory uncertainties and impediments are removed these transactions will become simpler and less costly. This will allow a greater number of insurers, including smaller insurers, access to the capital markets to cover their catastrophe exposures.

Some investors rely on public ratings to validate their own internal risk assessments. Some are required by law to invest in securities with such ratings. The fact that rating agencies can now rate catastrophe exposure funding transactions adds immeasurably to the willingness and ability of investors to dedicate a portion of their portfolios to natural disaster risk funding. Moreover, rating agencies can give impetus for regulatory comfort with these transactions. For example, recently the NAIC awarded bond risk-based capital status (versus equity status which carries a much higher capital requirement) to principal and/or interest at risk catastrophe-linked securities held for investment by insurers as long as those securities have acceptable debt ratings from public rating agencies. This will be an important factor in the ongoing ability and willingness of life insurers to invest in these transactions.

1. **Federal Tax Issues:** From a federal tax viewpoint there are several issues that result in catastrophe-linked securities being extremely complicated and costly to structure, market and administer. Most of these complications and costs derive from issues that need to be resolved to achieve the basic tax goal of these structures—to avoid an entity level tax on the investors' return on the securities. Some additional issues arise out of whether the SPRC, the marketers of the securities and the investors in the securities issued by the SPRC are conducting insurance business and therefore are subject to state insurance licensing and other insurance regulatory requirements. Suggestions are presented below.

The federal tax issues revolve around three basic uncertainties:

- whether the issuer of the securities (the SPRC) is an insurance company under state insurance codes,
- whether the SPRC is in the trade or business of writing insurance, and
- whether the securities are debt instruments or "something else" for federal income tax purposes.

If the insurer is formed in the United States and is considered to be an insurance company, it may be a "per se" corporation. In that case, at a minimum, the return earned by equity investors in the SPRC would be subject to an entity level tax. Compounding the problem is uncertainty about whether event risk debt instruments issued by the SPRC are debt for federal income tax purposes. If they were considered equity in the SPRC, the SPRC would not be entitled to a deduction for interest paid thereon. This would make the securitization uneconomic.

For these reasons, the SPRC in recent transactions has been formed in a foreign jurisdiction. If it is considered to be in the insurance business, the corporation receives fixed, determinable, annual or periodical ("FDAP") income or it is engaged in a U.S. trade or business. The Contract Payment is treated as FDAP and the SPRC pays U.S. tax on it. The SPRC's activities are structured so that it does virtually nothing in the U.S., except possibly selling its securities. Accordingly, it would not be engaged in a U.S. trade or business.

The problem with this structure is that it brings substantial inefficiencies to the transaction. Since great care must be taken to avoid U.S. trade or business issues, meetings and communications all take place outside the U.S. This is cumbersome for the sponsor. From the investor's standpoint the Event Risk Debt Instruments may be considered equity in a passive foreign investment company ("PFIC"). As such, the investor will be subject to PFIC's anti-deferral regime or be required to make a qualified electing fund ("QEF") election. Either possibility departs from the normal federal income tax treatment of a debt instrument. This, in turn, reduces the economic efficiency of the structure.

Suggestions: The U.S. Treasury should be encouraged to address the following federal income tax issues so catastrophe-linked debt securities can be efficiently structured to permit U.S. insurance companies and other SPRCs to use the capital markets to fund natural catastrophe exposures. The intent of these changes would be to designate SPRC's as pass-through entities that would not be taxed as a separate corporation.

- **Entity Classification:** The Treasury should provide, through regulations or a published ruling, that an entity that enters into a single contract to insure risk is not a per se corporation. This change is warranted because such activity should not rise to the level of a "trade or business" (see below). Nor should it be considered an "insurance company" because there are none of the normal

indicia of an insurance company. The SPRC does not write insurance policies other than the single contract. It is not regulated as an insurance company under state law. It has no insurance agents or employees. Accordingly, the per se classification of insurance companies should not extend to such one time securitization vehicles. As a corollary, the Treasury should provide, through regulations or a published ruling, that an individual or entity that purchases an Event Risk Debt Instrument does not become a per se corporation or other entity merely by holding such an instrument.

- **Trade or Business Issues**: The Treasury should provide, through ruling or regulation, that a corporation, other than a per se corporation, organized outside of the United States that enters into a single contract to assume the risk borne by another party should not be treated as being engaged in a trade or business in the United States. The rationale here is simply that a sole act, performed in connection with a corporation's formation, should not give rise to a trade or business. In other words, the mere act of writing the contract is not sufficiently "regular or continuous" to attract U.S. tax.

- **Stock or Securities Safe Harbor**: The Treasury should, through regulations, clarify that Event Risk Debt Instruments, are "securities" under section 864(b)(2) of the Internal Revenue Code (the "Code"). As such, a foreign corporation or partnership that "effects transactions" in such instruments would not be treated as being engaged in a U.S. trade or business. This change is important to permit an SPRC that is a U.S. person to issue Event Risk Debt Instruments to a foreign corporation or partnership that, in turn, sells securities backed by such instruments to the public. Such a clarification would be very helpful in persuading state insurance departments that Event Risk Debt Investments are not the business of insurance, an area of sufficient uncertainty that the marketing of those securities in certain states has been avoided.

- **Nature of the Event Risk Debt Instrument**: The Treasury should provide, through regulation or a published ruling, that interest payments on Event Risk Debt Instruments are not excluded from the portfolio interest exemption from U.S. federal withholding tax by virtue of section 871(h)(4) or 881©(4) of the Code. Although there is no single definition of debt for U.S. federal income tax purposes, it is often described as an unconditional promise to pay on demand or on a specified date a sum certain in return for an adequate consideration in money or money's worth. Accordingly, when it is uncertain how much of the principal amount on a security will be repaid because repayment of the security is dependent upon a contingency outside of the control of the SPRC, as here, it is not entirely clear under current law that what one has is debt. Nevertheless, there seems to be no policy reason to treat interest on Event Risk Debt Instruments as contingent or to not treat such amounts as interest. Instead, efficient securitization of event risks should be facilitated by clarifying the treatment of interest on Event Risk Debt Instruments.

- **Nature of Premium Payments**: The Treasury should clarify, through regulation or a proposed ruling, that payments received by entities that enter into a one time contract to insure a third party against a specified risk are treated as insurance premiums on a single insurance contract, that are subject to U.S. tax as insurance premiums. This would provide further indicia that the SPRC has not engaged in a trade or business in the U.S. on a continuing basis.

2. **State Regulatory Issues**: Securitization transactions result in the sale of securities under the various state laws. Due to their linkage to the insurance business, several insurance regulatory issues have had to be addressed in structuring these transactions.

   - **Insurance Department Approvals:** Recent large event risk securitizations have required state insurance department approvals or opinions on a number of items to ensure a positive federal income tax outcome and to avoid potentially costly and complicated licensing and registration requirements for the SPRC. These items include:

     - The securities would not be deemed insurance contracts, insurance policies or reinsurance contracts.
     - The holders of the securities would not be deemed to be doing an insurance business or to be insurers or reinsurers by virtues of the securityholders' purchase, ownership or holding of the securities.
     - Accordingly, the securityholders would not be required to be licensed as insurers or reinsurers by virtue of the securityholders' purchase, ownership or holding of the securities.
     - There is no basis under the insurance code why the securities are not enforceable in accordance with their terms.

     Most, but not all state departments agreed with these statements via private rulings or opinions. The securities were not marketed in those states that did not confirm these statements.

     Suggestion: Codification of the above positions would remove any uncertainty as to future treatment of these types of securities, would reduce the administrative delay and cost associated with obtaining state-by state approvals for future deals and would create a favorable climate for the evolution of this important market. New York may also be a positive influence to other states to do this either through the National Conference of Insurance Legislators or the National Association of Insurance Commissioners.

   - **New York Risk-based Capital treatment:** Governor Pataki has submitted a Governor's Program Bill for risk based capital (RBC) standards for property/casualty insurers. The treatment of catastrophe-

linked debt securities in the determination of risk-based capital of an insurer that invests in these securities has been addressed by the NAIC. The result was that such securities rated by a nationally recognized rating agency as debt would be accorded favorable bond treatment. This removes significant barriers to Life and P&C insurers acting as investors in these securities. New York may need to specifically address this issue in its own minimum capital requirements.

Suggestion: Since New York has not yet adopted the NAIC risk-based capital regime, it would be helpful to ensure that any adverse treatment in determining minimum regulatory capital under New York RBC would be likewise removed.

- **Future State Regulatory Issues:** If the Treasury Department agrees to accommodate the formation of SPRC's in onshore U.S. on a tax-advantaged (pass-through) basis, there may be issues of how those entities are dealt with under state regulation and taxation. Any effort to impose new state and local taxes on these entities would have similar chilling effect on their economic viability, as do federal taxes now.

  Suggestion: When and if SPRC's are granted pass-through domestic tax status at the federal level, states should also recognize SPRC's as pass-through entities for premium taxes and other state corporate taxes. New York can again provide leadership for such an effort through regulatory and legislative trade associations.

II. Survey of Transactions Involving Capital Markets

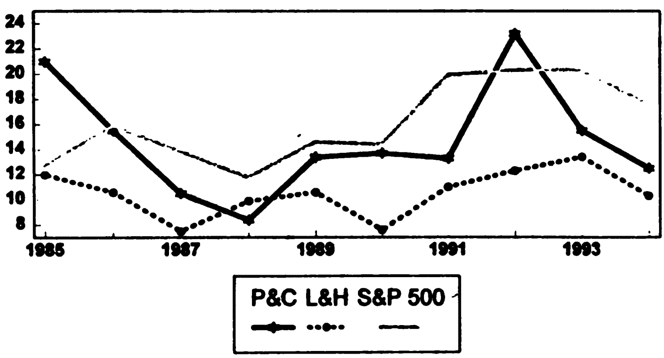
A. Privata Capital Market Initiatives

Background

Both the private market and government-created funds use capital markets in order to distribute catastrophic risk. Capital market involvement in providing capital to the insurance marketplace has existed for decades in the form of publicly traded insurance companies. It is only in recent years, after the dramatic rise in catastrophe loss occurrences, that innovative market professionals have sought to satisfy investors' demand for greater returns by developing catastrophe risk as a new asset class. Applying sophisticated techniques, they are bringing to the marketplace instruments bearing characteristics widely used in financial markets. A broader base of investors providing risk capital in highly specialized circumstances is a likely outcome of this innovation.

Insurers' return on equity traditionally has lagged other industries. The graph, *Average P/Es for Publicly Traded Insurers*, compares property-casualty insurers' P/E ratios to life and health insurers and to the S&P 500.

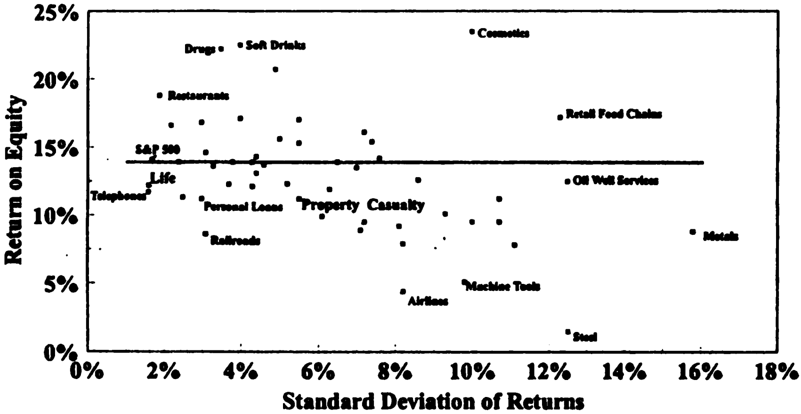
Average P/E's for Publicly Traded Insurers



The graph on the following page, *Context for Insurer Returns*, compares average returns on equity (RoE) to standard deviation of returns (a reasonable proxy for risk) amongst various industries.

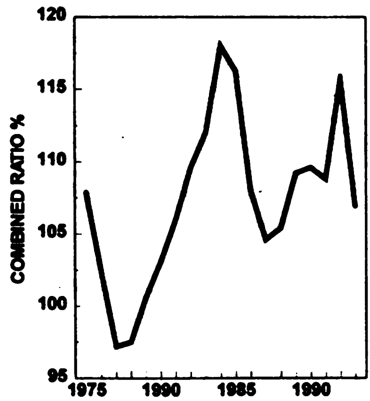
Context for Insurer Returns

Average RoE vs. Standard Deviation of Returns for Various Industries



Historically, the property/casualty industry is particularly volatile. Using combined ratios as a measure of profitability, the graph, *P&C: A Highly Cyclical Industry*, points to traditional cycles as experienced between 1975 and 1993, before significant development of catastrophe risk-based securities.

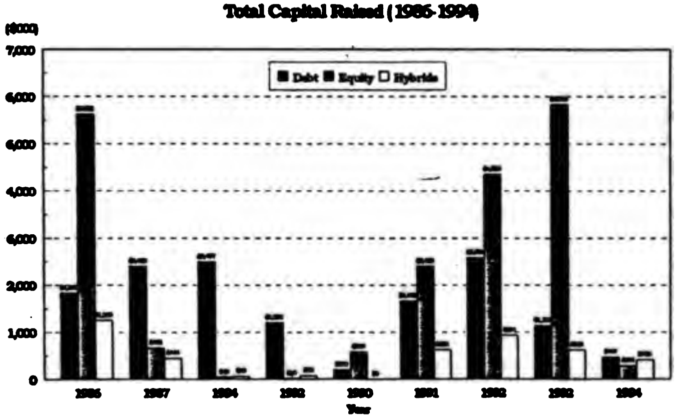
P&C: A Highly Cyclical Industry



To the extent that pure catastrophe risk provides a truly non-correlated asset (i.e., one that is not tied to fluctuations in the stock market), potential RoE on this asset class rises dramatically. Its attractiveness to investors is enhanced.

Capital market investors first participated in the catastrophe market through the funding of over $5 billion in seven companies in just two short years to create the Bermuda catastrophe reinsurance market. In this instance, investors opted to provide capital behind professional underwriting talent. Sophisticated catastrophe models fostered expectations of optimized returns based on a geographic spread of risk. The graph on the following page, *Total Capital Raised*, illustrates the diversity of investment instruments that proved so attractive to investors between 1986 and 1994.

Total Capital Raised (1986-1994)



Encouraged by the apparent emergence of new competitive opportunities, 14 major risk securitization initiatives were brought to market with great success in 1995 through 1997. The following exhibit, *Securitizing Natural Disaster Risk*, lists and briefly describes these initiatives, and illustrates the diversity of these innovations that are designed to expand and strengthen insurer capacity, liquidity, and competitiveness.

Securitizing Natural Disaster Risk
(Prepared by RAA, January 1998)

Nationwide - Nationwide has the option to issue up to $400 million of 9.222% surplus notes to fund new business opportunities or as reimbursement to catastrophic losses. Contract with Morgan Guaranty Trust Company. (1995)

Stata Farm - A $3 billion revolving credit facility has been set up for State Farm to cover catastrophe losses. The deal was arranged by J. P. Morgan Securities, Inc. (1995)

Arkwright - Arkwright has set up a trust to issue $100 million in trust notes to private investors. New proceeds of the notes will be used to buy government securities held by the trust. (1996)

AIG Combined Risks/Benfield - Placed 5 catastrophe-linked bonds with an investment fund managed by Mercury Asset Management. Bonds will pay out if a catastrophe exceeding an agreed trigger occurs in: U.S., Japan, Australia, Caribbean, Europe or Japan. (1996)

Hannover Re - Sold $100 million worth of catastrophe cover. The portfolio-linked swap is comprised of the following: Japanese earthquakes, U.S. natural catastrophes, Canadian natural catastrophes, North European storms, North European other catastrophes, Australia - all catastrophes and aviation excess of loss. (1996).

St. Paul Re - $68.5 million deal through Goldman Sachs & Co. to increase capacity. St. Paul Re will cede reinsurance business from five classes under a 10 year reinsurance treaty. Investors participate in excess-of-loss underwriting by investing in bonds or preference shares. Enables St. Paul to increase capacity in 5 excess-of-loss classes: U.S./Caribbean property-casualty, European property-casualty, other property-casualty, retrocessional/Lloyd's short-tail and marine and aviation. (1997)

Winterthur Swiss Insurance Group - Placed $282 million of catastrophe bonds in private capital market. The bonds cover Winterthur exposure to auto claims stemming from domestic summer hailstorms. Transaction managed by Credit-Suisse First Boston. (1997)

Swiss Re - Placed $137 million in two-year bonds tied to reinsurance losses from a potential California earthquake. Swiss Re and Credit Suisse First Boston were the placement agents for the notes. (1997)

Horace Mann Educators Corporation: Agreement allows Horace Mann to receive up to $100 million from Center Re, the transactions underwriter, in exchange for an

equivalent value of its convertible preferred shared in the event of a mega-catastrophe. (1997)

RLI Corporation - Aon Re Services developed a $50 million catastrophe equity put (CatEPut) for the RLI Corporation. The deal was underwritten by Centre Re. In the event of a catastrophe that exhausts RLI's traditional reinsurance coverage, the CatEPut program allows RLI to sell up to $50 million in preferred shares to Centre Re. (1997)

USAA - Placed $400 million of hurricane bonds in the private placement market. The bonds will provide USAA with an excess-of-loss cover tied to a single hurricane producing losses of more than $1 billion during a one-year reinsurance period. The syndicate managers were Merrill Lynch & Co., Goldman Sachs & Co. and Lehman Bros. (1997).

LaSalle Re - Aon Re, Inc. and Aon Securities Corporation developed a $100 million multi-year Catastrophe Equity Put (CatEPut) option program for LaSalle Re. The option program allows LaSalle to issue up to $100 million in convertible preferred shares in the event of a major catastrophe or series of large catastrophes that result in substantial losses to LaSalle Re. (1997).

Reliance National Insurance Company - Completed a $40 million securitization of non-catastrophe coverage for its property, aviation, marine drilling and satellite launch exposure. The placement ties bond payment trigger points to a catastrophe index established by Swiss Re. Sedwick Lane Financial structured the deal (1997).

Tokio Marine & Fire Insurance Co., Ltd - Tokio Marine has acquired earthquake risk coverage of $90 million purchased from capital markets investors through Parametric Re, Ltd. Parametric Re issued 10-year fixed income securities with principal reduction contingent on the occurrence and severity of earthquakes within an area centered on Tokyo. Goldman, Sachs & Co. and Swiss Re Capital Markets Corporation were co-leaders for the transaction.

It was widely believed that the ability of capital markets to sustain this momentum in light of the increasing oversupply of traditional reinsurance capacity would hinge on the occurrence of a "defining event." The awaited catalyst would, investment experts and insurers agreed, most likely be either a large loss that would trigger a significant contraction in capacity, or a single entity going to market with a large catastrophe bond offering. Experts now believe that 1997's USAA transaction (see *Securitizing Natural Disaster Risk*) could be the defining event.

Impact on Cost and Availability of Homeowners Insurance

Capital markets provide the tools that allow the marketplace to assume greater risk. In each of the 14 private industry deals completed to date, the participating companies negotiated risk protection specifically tailored to their financial needs. Capital market arrangements provide the extra protection that allows companies to feel comfortable with the risks they have or will assume. The New York homeowners insurance marketplace is realigning around this more comfortable capacity. New entrants, and the return of some insurers that had imposed a freeze on New York coastal underwriting, should continue as catastrophe risk investment becomes more popularized.

Since Hurricane Andrew, the private marketplace has increased its ability to address its catastrophic exposures. In fact, a lot has happened since that storm touched down 5 years ago, reflecting the industry's ability to absorb large losses. The property-casualty insurance industry's surplus has increased over 70%, from approximately $163 billion in 1992 to approximately $280 billion in 1997.

Insurers and investment professionals use advanced forms of risk modeling to assess accurately their exposures to natural catastrophes, including coastal events. Individual companies have restructured their operations to reflect the unique exposures they face in different regions of the country. States are addressing rate and coverage flexibility, including deductibles. Reinsurance capacity has increased. Capital markets continue to develop innovative securitization techniques aimed at tapping a massive new source of private sector capacity.

Together, these developments have resulted in an insurance marketplace that is more reflective of actual risk, more responsible to policyholders, and more responsive to market opportunities. As evidence of this emerging strength, companies have expanded their writings in exposed areas such as Long Island. Some of these positive market indications are the result of insurers feeling more confident about their retained exposures. Some also are the result of new companies being formed to serve particular segments of the marketplace. Many are directly related to significant new reinsurance and capital markets arrangements. They reflect a renewed private marketplace that, through the combination of better data, new capital, and flexible regulation, is addressing the market dislocation problem successfully.

B. Public Sector Programs

Integration of Capital Market Products In Claims Paying Ability of Public Entities

During the same period in which primary insurers instituted catastrophe management plans in response to rating agency and investor concerns, public residual market facilities grew dramatically, compared to historical patterns. Hurricanes Andrew and

Iniki, and the Northridge Earthquake, led existing and newly created residual markets in Florida, Hawaii, and California to look to enhance their claims paying resources.

In the private sector, capital markets provide dedicated capital to expand writing in particular lines of insurance (such as coastal exposures) within a diversified portfolio, across a geographic spread of risk. Public sector catastrophe funds, on the other hand, offer none of the benefits of diversification. They continue the concentration of the risk. Consequently, these state funds have been and will be less attractive to capital providers (investors) because of the higher likelihood of loss.

To date, public entities' access to capital has been at the debt end of the market, primarily syndication of loans. These residual markets accessed the *loan syndication market* to the tune of $4.75 billion, with the expectation that up to another $8-10 billion will be available after a large loss occurrence.

Following is a description of several public sector programs that in varying degrees integrate the private capital markets responses with public entity funding needs.

FLORIDA

Residential Joint Underwriting Association

State Action - The FRPCJUA was created in January 1993 in response to an insurance availability crisis caused by Hurricane Andrew. FRPCJUA is not a state agency. It provides coverage in all 67 counties of Florida, but will not write wind coverage in areas covered by Florida Wind Underwriting Association (FWUA). FRPCJUA provides both residential and commercial residential coverages. Successful depopulation plans have removed over 400,000 policies from FRPCJUA. Adverse selection and new policies written, however, have thus far prevented proportionate reduction in probable maximum loss.

Claims Paying Capacity, in likely order of pay out (bottom up):

$?	**Post-Event Notes** (Issued after catastrophe)
$1.4billion	**Credit Facility** (Global bank syndication led by JP Morgan)
$450million	**Pre Event Notes** (Led by JP Morgan)
$1.38billion	**Reinsurance CAT Fund** (90% Participation)
$377million	**Regular Assessments** (On servicing insurers)
$150million	**Estimated GAAP Surplus** (Total assets $135 million)

Sources of Financing - FRPCJUA can make regular assessments on insurers, based on prior year market share, up to the greater of 10% of statewide premium for covered policies or 10% of deficit. If this is not sufficient to pay claims, emergency assessments can be levied annually according to the same formula. Additional emergency assessments have been pledged as collateral for credit facilities. This assessment

amount can be increased to repay costs and fees of post-event bonds. No estimates available for post-event bonding capacity. FRPCJUA assessed insurers in 1996 for $40.5million deficit.

Florida Windstorm Underwriting Association

State Action - FWUA was created in 1970. It is not a state agency. FWUA provides coverage for perils of wind and hail in 29 of 35 coastal counties, and issues both residential and commercial policies.

Claims Paying Capacity:

$?	**Post Event Notes** (Issued after catastrophe)
$1.75billion	**Credit Facility** (Global bank syndication led by JP Morgan)
$750million	**Pre Event Notes** (Led by JP Morgan)
$300million	**Traditional Reinsurance**
$1.225billion	**Reinsurance CAT Fund** (90% Participation)
$322million	**Regular Assessments** (On servicing insurers)
$90million	**Estimated GAAP Surplus**

Sources of Financing - FWUA can make regular assessments on insurers, based on prior year market share, up to the greater of 10% of statewide premium for covered policies or 10% of deficit. If this is not sufficient to pay claims, emergency assessments can be levied annually according to the same formula. Additional emergency assessments have been pledged as collateral for credit facilities. This assessment amount can be increased to repay costs and fees of post-event bonds. There are no estimates available for post event bonding capacity.

Hurricane Catastrophe Trust Fund

State Action - The CAT Trust Fund was created to provide affordable reinsurance capacity to insurers after Hurricane Andrew. The CAT Fund is a public entity, operating with the State Board of Administration. The CAT Fund collects approximately $456 million in premium annually. Insurers writing residential property business in Florida must participate. Options are 45%, 75%, and 90%. Participation is based on a catastrophe model that develops an actuarially adequate rate. The CAT Fund has accumulated $1.97 billion in capital. The IRS has ruled that the Florida Hurricane Catastrophe Trust Fund is exempt from federal income tax.

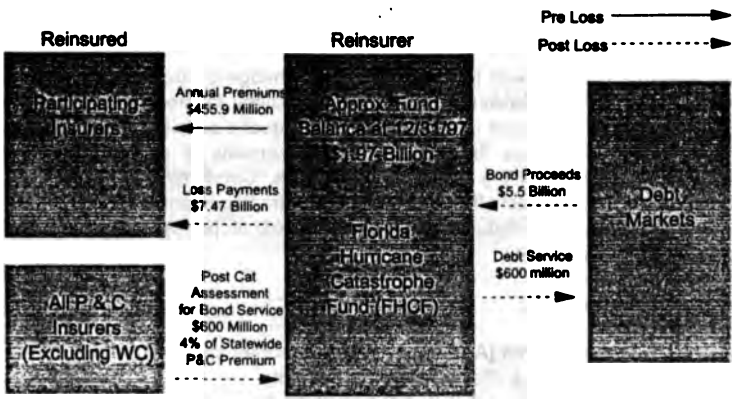
Claims Paying Capacity - The CAT Trust Fund is required to advise all companies of its estimated maximum claims paying ability annually. The estimated capacity is based on the CAT Trust Fund's estimated post-loss bonding capacity, which in turn is based on the Fund's assessment authority. For 1997, the estimated bonding capacity was $5.5 billion. Combined with the current balance, the total estimated claims paying

capacity is $7.47 billion. Insurers are advised that the CAT Trust Fund will pay proportionately to its actual available funds.

Sources of Financing - The CAT Trust Fund can assess up to 4% of the statewide premium for all property and casualty business, excluding workers' compensation. The anticipated annual debt service, based on a $4% assessment charge, is $600 million. A flow chart, below, (*Florida Hurricane Catastrophe Fund*) illustrates revenue flow for the 1997-98 contract year.

Florida Hurricane Catastrophe

Flow Chart: 1997/8 Contract



HAWAII

Hurricane Relief Fund

State Action - HHRF was organized after Hurricane Iniki caused $1.6 billion in damage. HHRF is a state agency operating within the Department of Consumer Affairs. The facility offers hurricane coverage to all homeowners in the state of Hawaii. Insurers writing business in the state who choose not to write hurricane peril act as servicing entities and issue policies on behalf of HHRF. Insurers are subject to assessment, based on market share. The assessment is capped at $500 million. The IRS has ruled that the HHRF is exempt from federal income tax.

Claims Paying Capacity:

$750 million	**Credit Facility** (Administered by Bank of Hawaii)
$600 million	**Reinsurance** (Traditional and Finite Risk)
$500 million	**Assesements** (On servicing insurers)
$90 million	**Paid-In-Capital** (Total Assets $135 million)

Sources of Financing - Credit facility and a portion of reinsurance are supported by current premium income. Additional revenue is generated from a special mortgage recordation fee. There also is a quarterly assessment of 3.5% on all property-casualty premiums, excluding auto, health, and workers' compensation.

CALIFORNIA

California Earthquake Authority

State Action - The CEA was formed after the Northridge Earthquake in 1994. It is an agency of the State of California. All property-casualty insurers within California are members. Members produce and service the earthquake policies. The state manages the CEA facility that pools the risk. Coverage consists of earthquake policies for personal lines only, including Homeowners, MHOs, Condominium Owners, Renters, and Tenants. Coverages offered for Structure (replacement costs, same limit as insured's fire policy, 15% deductible); Contents ($5K limit, per replacement costs); Loss of Usage (capped at $1.5K).

Claims Paying Capacity:

$2 billion	**Assessments** (Additional, on CEA member insurers)
$1.5 billion	**Reinsurance** (Reinsurance Agreement)
$1 billion	**Revenue Bond** (Financed through premiums and assessments)
$2 billion	**Traditional Reinsurance**
$3 billion	**Assessments** (On member insurers and retained earnings of CEA)
$1 billion	**Initial Capital** (From CEA member insurers, by market share)
$10.5 billion	Total

Sources of Financing - Using a combination of assessments, reinsurance, and debt financing, the CEA can mobilize $10.5 billion of claims payments. It is important to note that, because of the substantial deductible (15%), this capital will provide claims payments for losses well in excess of a Northridge size loss. Northridge was estimated at only $4.3 billion loss to the CEA during the 1996 renewal versus actual insured loss amounts of about $12.5 billion.

C. Implications of Securitization on Private and Public Entities

Some experts hailed the success of recent capital markets initiatives as the beginning of the eventual securitization of all insurance risk. Many compared this evolution to early (and enormously successful) efforts to securitize mortgage pools. Others believe that any utilization of capital markets could not be competitive with the ample, excellently priced capacity available from the traditional reinsurance marketplace.

The oversubscribed Residential Re hurricane catastrophe bond, designed to transfer risk from USAA to investors, may have changed some minds. Investors, in significant numbers, clearly were willing to take on catastrophe risk in fixed income securities.

Capacity generated but not used by the USAA deal (over $200 million) was offered to both residual market insurers in Florida. Both these public entities already had accessed debt markets to a significant degree (see *Securitizing Natural Disaster Risk* above). However, budgetary constraints and insufficient time left the new capacity untapped.

Pre-Pay vs. Post-Pay

With either traditional private sector insurance/reinsurance, or private capital market products, the cost of any loss event is calculated into the current premium. Therefore, there is no retroactive assessment upon policyholders or taxpayers at the time of loss. In contrast, the capital made available to public entity CAT funds is, in substance, a loan that must be repaid after the loss. This repayment generally triggers retroactive assessments on policyholders directly, and may trigger further assessments upon insurers writing in the state (which ultimately spill back onto policyholders as a further cost increase).

Prognosis

The appetite for risk-based investment appears strong. The market continues to innovate in response to investor interest. A growing number of over-the-counter contracts and hedge instruments have found acceptance. The Chicago Board of Trade continues to develop trading in catastrophe options and other derivatives. The Bermuda Commodities Exchange, which uses the Guy Carpenter Catastrophe Index as a basis for its catastrophe options, further expands the capital base available to finance catastrophe risk. Collectively, these innovations in transferring catastrophe risk to third party investors will help provide greater price stability to hedgers while improving portfolio diversification for both hedgers and investors.

The jury is still out as to how the market for insurance securitization will develop. No one product or structure has yet gained preeminence for either hedgers or investors. Insurance securitization, like other capital markets, will likely develop many different kinds of product choices designed to meet the disparate needs of the broad spectrum

of insurers, reinsurers, and investors. One thing is certain: the capital markets component of risk transfer will take on increasing importance as insurance professionals develop a greater degree of comfort with the new products. A sophisticated, dynamic RoE-based model of risk transfer and financing will become commonplace.

Conclusion

The threshold question for public entities and private security transactions is not whether securitization is viable for public entities. Capital markets professionals and reinsurance innovators will continue to evolve new products to bring needed capacity to the marketplace. In light of the abundant and affordable risk capital available, the core question should be, *Should public entities be structured and financed by government to compete with the voluntary markets?* -- a question addressed elsewhere in this *Report.* *(See p. 22.)*

III. New York Insurance Department Initiatives to Facilitate Capital Market Development of Catastrophe Risk Financing

The New York Insurance Department has been at the forefront of developing and encouraging innovative approaches to the financing of natural catastrophe insurance exposures. In recognition of the fact that traditional insurance and reinsurance mechanisms may not provide necessary capacity to absorb major catastrophe events (e.g. Class 4 hurricane on Long Island, New Madrid Earthquake), these approaches involve accessing the capital markets as well as developing new approaches to more efficiently spread the risk within the insurance and reinsurance industry. The Department's initiatives include: encouraging proposals that access capital markets through the use of catastrophe bonds and similar instruments; authorizing the use of the Chicago Board of Trade (CBOT) derivatives; authorizing CATEX as a reinsurance intermediary; proposing legislation that permits the issuance of Capital Notes; considering legislation to permit structured reinsurance companies; and developing a model for a tax deductible pre-event catastrophe reserve on a national level. Some of the following initiatives are, *prima facie*, capital market approaches while the remaining ones have the potential to be integrated with capital market approaches in the financing of natural catastrophe risk.

Legal Interpretation of Capital Market Activities as Outside of the Scope of "Doing an Insurance Business"

In 1995, the New York Insurance Department was asked to provide confirmation that specific transactions that facilitated insurers' access to the capital markets would not be construed as doing an insurance business. These transactions involved the sale of securities by insurers that had variable interest payment and principal repayment obligations, the specific mechanics of which depended on the risk alleviation objectives of the issuing insurer. New York provided an appropriate and enlightened legal opinion that sellers and buyers of these securities would not be deemed to be doing an insurance business and they would not be required to be licensed as insurers under the insurance law. This opinion facilitated development of the sale of variable market debt securities as a way to finance catastrophe risk. Investment bankers and underwriters, armed with New York's opinion, have approached other states on these transactions and have secured from most of these states opinions or rulings consistent with New York's confirmation.

New York Insurance Law Authorization of Exchange-Traded Derivatives—Chicago Board of Trade

The Chicago Board of Trade (CBOT), the major market in the development of futures and options for the hedging of risk, has developed a derivative intended to assist insurers and reinsurers manage their underwriting exposure. The CBOT has begun the trading of PCS Catastrophe Insurance Options.

Under legislation enacted in 1993, New York insurers were authorized to engage in CBOT derivatives to hedge their insurance risks. That legislation was effective for a three year period and expired at year-end 1996. It was not extended mainly due to the sparse use of the derivatives by the insurance industry. However, consideration will be given to re-enacting this authority if there is industry interest in such authority.

An option of this type is a standardized exchange-traded contract whose price is based upon one of nine underlying catastrophe loss indices. These indices track losses on a national, regional and select state basis. As with other financial and commodity options, a buyer of this option has a right, but not an obligation, to exercise the option at a specific index value. Upon exercise, the buyer receives a cash payment equal to the amount that the settlement value of the underlying index is above or below the option strike value. An insurer engaging in these catastrophe options can effectively establish layers of protection against losses due to catastrophes, provided the insurer's book of business is correlated to the index underlying the options chosen. If that correlation exists, as the insurer's losses go up, the settlement price of the option increases in a similar fashion.

With these exchange-traded derivatives, non-insurers can use their capital to absorb catastrophic risk. The CBOT uses the Board of Trade Clearing Corporation (BOTCC) to ensure the integrity of the market. The BOTCC is a separate entity owned and funded by clearing member firms. BOTCC plays an integral role in all of the CBOT transactions, such as performing the daily matching of trades, collecting and holding performance bond margin funds, monitoring the open-position risk of members and traders, settling accounts daily, and reporting trade data. BOTCC is a third-party guarantor to all futures and options traded on the CBOT. For every transaction, BOTCC acts as buyer to the clearing member seller or as seller to the clearing member buyer. As a party to every trade, the BOTCC assumes the responsibility of guarantor. In the event a margin call cannot be made, the BOTCC uses it own capital and credit facilities to prevent contract default.

Although trading of PCS Catastrophe Insurance Options has generally been sparse, the CBOT has been working to develop the market and improve the product. As a result of this effort the volume of transactions has been increasing. This marketplace is an evolving one and, if it develops sufficient depth and liquidity, it could provide a viable alternate market for insures to spread their risk and for outside capital to more fluidly enter the insurance market.

New York Insurance Department Approval of the Catastrophe Risk Exchange, Inc.

Early in 1995, a proposal to provide a new method of distributing catastrophe risk among insurers was brought to the New York Insurance Department for review and approval. In the spring of that year, the Catastrophe Risk Exchange, Inc. (CATEX) was licensed as a New York reinsurance intermediary.

CATEX is designed to help insurers spread their catastrophic-related risks by creating an electronic marketplace for the posting, selling and exchanging of such risks among insurers. CATEX is the idea of former New Jersey Insurance Commissioner Samuel Fortunato.

Mr. Fortunato and the other principals of CATEX have established a facility whereby insurers and reinsurers sell or exchange exposures in a manner fundamentally similar to the trading of stock or commodities on the New York Stock Exchange, NASDAQ and various other regional stock or commodity exchanges. Using an open "bid and asked" market, or an exchange, risk-bearers will be able to diversify their potential liabilities by gaining access to wider distributions at minimal cost.

CATEX operates as a computer-based trading exchange, with CATEX subscribers gaining access to the trading system on a global scale. CATEX maintains a highly secure, yet flexible, electronic system, enabling interested subscribers to place and advertise risks they seek to place with other risk-bearing entities. Rates for individual trades are established by underwriters in response to real time market dynamics. Using a sophisticated, secure electronic mailbox system, risk-bearers and their brokers negotiate and complete trades. Trades are registered with CATEX and risk trading information is then published to CATEX subscribers.

What CATEX hopes to provide is a more effective means to distribute catastrophe risk. The use of an electronic distribution system will allow increased flexibility and cost saving in spreading risk. While this marketplace is being geared toward catastrophe risk, it can conceivably be extended to other insurance products.

It is important to note that CATEX itself will not function as a risk bearing entity, but will provide the mechanism and procedures to effectuate the exchange of risks. Since CATEX is providing the means for such exchange, it is acting in the capacity of a reinsurance intermediary. However, unlike traditional reinsurance intermediaries, which represent the interests of either the ceding insurer or the assuming reinsurer, CATEX will serve as a neutral party, whose sole function in the transaction is providing a medium in which the parties to the reinsurance agreement may get together.

Although transactions on CATEX are limited to risk-bearing entities (i.e. insurers) and, as such does not access capital form the non-insurance capital marketplace, there may be potential for the capital markets to eventually tie into the concept, as the risks marketed on the CATEX system are presented in a relatively standardized format,

which lends them to open transfer in an exchange-type setting. Indeed, CATEX plans to open a joint venture in Bermuda with the Bermuda Stock Exchange to establish a CATEX Bermuda. This venture would operate in the same fashion as the licensed New York CATEX, except it would permit non-insurers to accept risks, which cannot be done directly in New York and in most other states due to existing insurance laws. CATEX could act as a model for a more direct access to the capital markets in the future. It can also provide an electronic barometer of the price of risk assumption for non-insurers.

Proposed Legislation

A. Permit the Issuance of Capital Notes

In its 1998 Legislative Agenda, the Department has proposed reintroducing 1997 legislation that would expand the means by which property/casualty insurance companies can raise capital by authorizing the issuance of capital notes. This legislation is the property/casualty analogue of Section 1323 of the New York Insurance Law, which was enacted in 1996 and made applicable to life insurers. Currently, mutual property/casualty insurance companies can only raise capital from investors by issuing surplus notes pursuant to Section 1307 of the New York Insurance Law. Surplus notes have characteristics of debt instruments, but their attraction results from the fact that they are a treated as surplus (not as a liability) on an insurer's financial statement and thus included in total adjusted capital for risk based capital purposes. However, due to the regulatory restrictions on the payment of interest and repayment of principal on these debt instruments, this method of raising capital can be costly. Capital notes are constructed as a debt instrument that is carried as a liability on an insurer's balance sheet, but which may be added to total adjusted capital for purposes of calculating risk based capital. An additional feature of capital notes is that they contain automatic thresholds for payment of interest or repayment of principal. Thus, potential investors may require lower rates of return for capital notes than for surplus notes.

It is hoped that the existence of capital notes will widen access to the capital markets at a lower cost of capital. Capital notes could be used by both mutual and stock companies to finance their catastrophe risk. This could be accomplished, for example, in a structure similar to the 1995 Nationwide* arrangement to secure contingent capital, but by using capital notes instead of surplus notes. Alternatively, insurers could issue the capital notes directly to investors.

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* Under this arrangement, Nationwide was authorized, on a contingent basis, to issue surplus notes to Morgan Stanley if Nationwide needed access to capital due to a catastrophe or another operating need. Morgan Stanley signed a contract to sell the surplus notes (if issued) to a newly formed trust. The trust was funded by private investors and the proceeds were invested in $400 million of US Treasury securities. If Nationwide exercised its contingency financing option, those surplus notes would be substituted for an equivalent amount of Treasury securities held by the trust.

B. Authorize the Formation of Structured Reinsurance Companies (Which are Entities Formed to Market Securitized Reinsurance Agreements)

The Department is considering legislation that would facilitate and permit the licensing and operation of structured reinsurance companies in New York State. Structured reinsurance companies are an essential component in the securitization of insurance risk. These companies are formed to assume insurance risk under single or multiple structured reinsurance agreements from ceding insurance companies. Funding of the structured reinsurance company's potential obligations under the reinsurance agreement is financed by the issuance or sale of securities in the capital markets. Investors in such securities risk loss of principal or interest in the event the losses (or other triggering points) specified in the reinsurance contract are realized.

This proposal would facilitate ceding insurers' access to the capital markets as an alternative to traditional reinsurance protection, especially where capacity for such protection is not available in the traditional market. The nature of a structured reinsurance company, fully or largely funded by the capital markets, offers the potential for lowering cost to ceding insurers. Such cost savings can be passed on to policyholders of the ceding insurer, including New York policyholders.

The State of New York will benefit by encouraging the establishment and licensing of entities seeking to engage in structured reinsurance transactions. Under the proposal, New York's statutory, regulatory and licensing requirements for these vehicles would be more comparable to those of Bermuda and the Cayman Islands—jurisdictions in which structured reinsurance vehicles are often domiciled—making this state an attractive alternative to locating offshore. In addition, companies licensed in New York would not be subject to the 1% Federal Excise Tax to which entities licensed in Bermuda or the Cayman Islands are subject. The bill will promote the growth of the state economy by permitting structured reinsurance companies to form and locate in New York.

It is important to note that in order for this proposal to be feasible, a "cut-through" federal tax treatment to the investors in the structured reinsurance company, rather than taxation of the reinsurance company itself, is essential. Other tax issues also require clarification. To date, the IRS has not been approached by the New York Insurance Department on these issues.

Conclusion

The property and casualty insurance industry's surplus base is approximately $260 billion at the end of 1996. It is clear that a major catastrophe or a series of catastrophes could significantly impact available surplus. The New York Insurance Department believes that the initiatives described above will better enable the insurance industry to meet the challenges posed by natural catastrophes. These initiatives encompass a wide range of private sector solutions to addressing catastrophic risk. Capital market solutions provide a means of transferring a portion of

the risk of natural catastrophes to the much larger and more diverse capital base than is currently available in the insurance industry.

The more effectively insurers securitize their catastrophic risk, the greater their capacity and willingness to write insurance in areas where there is a concentration of significant catastrophe risk exposures, such as areas on Long Island. Availability of insurance coverage is an essential part of the economic development of New York State.

Appendix

Review of Recommendations by the 1996 Temporary Panel on Homeowners' Insurance

The 1996 Temporary Panel on Homeowners' Insurance offered the recommendations enumerated below. Following each recommendation is a description of the current status of the proposal and the assessment of it by this year's Temporary Panel:

1. **CMAP participation/monitoring. The Superintendent should seek broader participation in CMAP, especially in the NYPIUA rotation process, and should closely monitor the growth of exposure in both CMAP and NYPIUA.**

   Current Status: Since the 1996 report, the Superintendent has been seeking broader participation in CMAP and has monitored the growth of exposures. This will continue.

   The 1998 State of the Market Subcommittee recommends that:

   efforts continue to encourage insurer participation. In addition, as more voluntary insurers introduce hurricane deductibles, it is important that NYPIUA introduce a catastrophe windstorm deductible program comparable to those in use in the voluntary market.

2. **CMAP standardization/outreach. The CMAP steering committee should make improvements in the application process and explore the development of a standard form of wrap-around coverage. They should increase efforts to inform and educate agents, companies, consumers and real estate professionals and ask that participating companies distribute detailed explanations of their CMAP procedures to their agents writing in CMAP eligible areas.**

   Current Status: In response to last year's recommendations, the CMAP steering committee considered but did not adept a standard form. The steering committee did undertake a public information campaign which resulted in the production and distribution of a consumer information brochure about the availability of coverage through CMAP.

<u>The 1998 State of the Market Subcommittee recommende that:</u>

CMAP extend its consumer education efforts and coordinate with the Insurance Department and its "member" companies a wide-ranging, broadly available information campaign to address the public's understanding of the relationshipe among availability, affordability, and loss exposure. Specifically, public awarenese needs to be increased about:

- **the increasing prevalence of catastrophe deductibles and the need to be alert to changes in homeowners insurance policies which introduce such deductibles;**
- **the nature of catastrophe deductibles, what events could trigger such deductibles, and the relationship of these deductibles to availability and affordability of homeowners coverage;**
- **how a percentage catastrophe deductible translates into dollar terms, and whether the consumer can afford to assume this exposure to loss; and**
- **possible mitigation steps homeowners can take, and how such steps could improve the availability and/or affordability of their homeowners coverage.**

3. <u>NYPIUA permanency/deductibles</u>. Legislation be enacted amending Section 5411 and Section 5412(g) of the Insurance Law to make NYPIUA permanent. NYPIUA should be given the authority to use hurricane deductibles similar to any which are approved in the voluntary market.

<u>Current Status</u>: NYPIUA is still not permanent nor does it have the authority to use hurricane deductibles.

<u>The 1998 State of the Market Subcommittee recommends that:</u>

these two recommendations not be linked in the 1998 report since they are separate and distinct. Therefore, recommendations to make NYPIUA permanent and to provide it with the authority to use hurricane deductibles are offered as separate recommendations in the 1998 report.

4. **Hurricane deductibles. The Insurance Department should approve appropriate mandatory deductibles for hurricane losses.**

Current Status: The Department has approved filings for deductibles for individual insurers that would be applicable to all of those insurers' policies in affected areas. There are no uniform standard deductibles applicable to all companies.

The 1998 State of the Market Subcommittee recommends that:

appropriate deductibles for hurricane losses be approved. The Department's standards for approval of hurricane deductibles should include a clear, prominent display of the dollar amount (as well as the percentage) of the deductible on the face of the policy and a clear, prominent explanation of the triggering event.

In addition, the Subcommittee believes that wind deductible trigger events should be measured solely by wind speed (not by storm surge or barometric pressure measurements) and should occur within a named hurricane.

Lastly, the Insurance Department should undertake a consumer education effort so that homeowners understand and remain alert for key policy provisions relating to hurricanes.

5. **Section 3425 amendments. Legislation should be enacted amending Section 3425 of the Insurance Law to facilitate prompt use of approved mandatory deductibles.**

Current Status: This item is becoming a moot point as companies phase in their deductibles over the three-year renewal cycle.

The 1998 State of the Market Subcommittee recommends that:

this recommendation be deleted from the 1998 report.

6. **Computer modeling. The Insu s the use and credibility of computer m**

Current Status: The Department continues to explore the suitability of computer modeling for determining rates and deductibles.

<u>The 1998 State of the Market Subcommittee recommende that:</u>

the Department concluds its study of computor modeling and consider permitting modeling to be used by insurers as another acceptable actuarial technique for the development of appropriate rates and deductibles.

7. <u>Catastrophe reserves</u>. Legislation should be enacted authorizing insurers to establish catastrophe reserves.

<u>Current Status</u>: This recommendetion is in need of clarification. The recommendation related to *state* legislation, while recommendation #8 related to *federal* tax policy. Since the 1996 report, no legislation has been enacted, on either a state or a federal level, that would allow insurers to receive appropriate tax benefits for establishing catastrophe reserves.

<u>The 1998 State of the Market Subcommittee recommende that:</u>

(See Recommendation #8 below.)

8. <u>Federal tax changes</u>. The Legislature should adopt a resolution calling on Congress to enact a natural disaster plan, including tax exempt accumulation of catastrophe reserves.

<u>Current Status</u>: Since the 1996 report, no legislation has been enacted, on either a state or federal level, that would allow insurers to receive appropriate tax benefits for establishing catastrophe reserves. This recommendation should be included in the 1998 report.

<u>The 1998 State of the Market Subcommittee recommends that:</u>

The Subcommittee has identified federal tax policy as one of the single biggest problems contributing to long-term market uncertainty for the homeowners product. While it is beyond the scope of New York State policymakers to effect direct change in this area, the Subcommittee urges that this point be kept in the forefront of any further discussion.

9. <u>NYPIUA Take-Out/Keep-Out program</u>. Legislation should be enacted amending Section 5405 of the Insurance Law to authorize NYPIUA to establish a hurricane exposure-related Take Out/Keep Out credit provision.

<u>Current Status</u>: This recommendation left many unanswered questions regarding the types of incentives that could be provided to insurers to encourage them to voluntarily take out NYPIUA risks located in hurricane-prone areas. Perhaps due to these unanswered questions, no Take-Out legislation has been enacted in New York since the 1996 report was issued.

<u>The 1998 State of the Market Subcommittee recommende that:</u>

a Take-Out/Keep-Out credit program be authorized that includes meaningful incentives.

10. <u>Hurricane pool</u>. A majority of the panel recommende that legislation should be considered to authorize the Superintendent to establish a Hurricane Pool within NYPIUA, if necessary, in preference to writing homeowners insurance in NYPIUA, which is the only alternative authorized by current law. Such legislation should include standards defining the funding of and assessment base for the Hurricane Pool and related policy considerations of such funding. Some members of the panel are unable to support this recommendation because they are concerned that "Hurricane Pool" is subject to a wide range of possible designs. One panel member would prefer homeowners insurance in NYPIUA.

<u>Current Status</u>: A Hurricane Pool has not been established within NYPIUA. A major factor impeding the establishment of such a pool is the fact that NYPIUA is not a permanent entity. Should NYPIUA gain permanence, it could attract the funding necessary to establish a Hurricane Pool.

<u>The 1998 State of the Market Subcommittee recommends that:</u>

Legislation be enacted amending Section 5411 and Section 5412(g) of the Insurance Law to make NYPIUA permanent.

48-232 98 - 9

STATEMENT OF THE AMERICAN INSURANCE ASSOCIATION

U.S. House of Representatives
Committee on Banking and Financial Services
Hearing on H.R. 219, the Homeowner's Insurance Availability Act of 1997
April 23, 1998
Statement of the American Insurance Association

American
Insurance
Association

The American Insurance Association is a national trade organization of property and casualty insurers.

U.S. House of Representatives
Committee on Banking and Financial Services
Hearing on H.R. 219, the Homeowners' Insurance Availability Act of 1997
April 23, 1998
Statement of the American Insurance Association

The American Insurance Association ("AIA") is a trade organization comprised of more than 300 insurance companies who provide residential and commercial property coverage throughout the United States. AIA is deeply concerned about the catastrophe exposures and related economic concerns facing insurers and society at large. For more than a decade, we have pursued enactment of federal legislation to assure that a massive disaster does not threaten the solvency of the property/casualty insurance industry or impair insurers' ability to meet the diverse needs of policyholders and claimants.

AIA believes that there is an important role for the federal government to play in improving our nation's catastrophe insurance system. We believe this role best can be fulfilled through federal legislation that establishes a federal excess-of-loss program to create a new, albeit limited, level of federal involvement in preparing for and responding to the most serious catastrophic events. This legislation should maximize the role of the private sector in managing and financing catastrophe risk, while recognizing that there are some major events for which private sector capacity is simply inadequate.

The Scope of the Problem Is Huge and Growing

Natural disasters are a national problem requiring a national solution. Seismologists have identified 39 states at risk for a significant earthquake, while meteorologists believe that 17 states are in the path of destructive hurricanes. Several states have a serious exposure to both of these perils. Over our nation's history, every region of the country has been hit by one or more ruinous disasters, including the New Madrid, Missouri, earthquakes of 1811-12; the Galveston, Texas hurricane of 1900; the San Francisco Earthquake of 1906; the New York/New England hurricane 1938; the Mississippi/Alabama hurricane of 1969 (Camille); the South Carolina hurricane of 1989 (Hugo); the Florida/Louisiana hurricane of 1992 (Andrew); and the Northridge (California) earthquake of 1994.

While the entire span of U.S. history has been punctuated by massive disasters, the problem has become more acute in recent years. During the past decade, seven of the eight most severe catastrophes, in terms of inflation-adjusted insurance losses, have occurred (Hurricane Andrew, the Northridge earthquake, Hurricane Hugo, Hurricane Opal, Winter Storm Josh, the Oakland fire, and Hurricane Iniki). From a federal budgetary perspective, federal disaster relief payments also have increased precipitously. Between 1990 and 1994, taxpayers paid almost $45 billion in federal relief to disaster

victims ($16 billion in 1994 alone). Beyond the economic statistics lies a larger story that includes many homes destroyed, businesses disrupted, and lives lost.

Although 1997 was a relatively quiet year for catastrophes, Congress should not become complacent. The absence of a major hurricane during 1997 is attributable to the temporary El Niño phenomenon, and not to any long-term shift in tropical storm patterns. Atmospheric Scientist William Gray, for example, predicts that El Niño's expected decline, plus the West African rainy season's return to normal, will result in a near average 1998 Atlantic hurricane season, followed by an era of average or worse hurricane seasons.

Moreover, even as the winds remained calm during 1997, the rapid population growth in the most hurricane- and earthquake-prone regions of the U.S. remained unchecked. By 2000, it is expected that 75% of the U.S. population will live within ten miles of the Atlantic, Pacific, or Gulf Coast in areas most at risk for severe earthquakes and hurricanes. More people mean that more homes and businesses are in harm's way, leading to ever larger catastrophe losses. Indeed, scientists and actuaries agree that the possibility of a catastrophe topping more than $25 billion is not at all remote. Yet, no sector of our nation's economy, including the insurance industry, is prepared for such an event.

In light of our disaster-afflicted history and the alarming prospects for the future, it is time for Congress to take action in order to assure that natural disasters do not dwarf our collective ability to pay for them. It is critical to enact federal legislation to help our nation prepare for whatever nature has in store.

AIA's Perspectives on Federal Natural Disaster Legislation

AIA believes that federal natural disaster legislation should address insurer solvency concerns that could result from a major catastrophe and promote the availability of property insurance in catastrophe-prone regions. It should not create a governmental insurance entity that replicates the private sector's risk management functions and capabilities, nor should it provide incentives for private carriers to underwrite irresponsibly. AIA also believes that the federal government has an important, on-going role to play in mitigation efforts to reduce the damage caused by catastrophic events.

AIA believes that a federal excess-of-loss program, structured along the lines of H.R. 230, is consistent with the aforementioned goals. Under such a program, the Department of the Treasury would administer an annual auction of excess-of-loss contracts. Each contract would provide a specified payout to purchasers experiencing claim losses due to a catastrophic event exceeding a high level, industry-wide trigger.

We believe that an excess-of-loss program offers important advantages over other options (including H.R. 219) which have been discussed.

First, it provides a mechanism for selling a fixed dollar amount of federal excess-of-loss contracts. As a result, the federal government does not face unlimited liability in the event of a super-catastrophe, as might be the case with a broader reinsurance or liquidity guaranty.

Second, the trigger is based solely on industry-wide loss levels, with no separate trigger based on individual company loss experience. This feature means that the government does not have to underwrite or price the contracts based on each individual company's (or state fund's) book of business, thus reducing transaction costs and minimizing potential conflicts between the federal government and state insurance regulators in evaluating a carrier's or state fund's exposure base.

Third, the trigger is designed at a high level so that the Treasury contracts do not displace available private insurance, reinsurance, or capital market capacity. This is consistent with the objective of maximizing the role of the private sector, a goal shared by members of Congress and the Treasury Department.

Fourth, the price of the contracts is expected to exceed the average expected annual loss costs for such coverage, thus underscoring that the program is not an insurance industry "bail out."

Specific program features are discussed below.

1. *The Federal Government Should Not "Bail Out" Insurers*

AIA does not believe that the federal government should "bail out" insurers who fail to prepare adequately for future catastrophes. Rather, we support establishment of a forward-looking mechanism that allows insurers to pay a fair price for financial protection in the event of a future catastrophe that is beyond the industry's capacity to fund loss. The sooner this mechanism is created, the more time it will have to collect the funds that will be needed if and when the "big one" occurs. One thing is clear--if Congress does not take the necessary steps to plan for future catastrophes, the chances of a "bail-out" at some time in the future will be higher than if a well-designed federal program is put in place today.

A federal excess-of-loss program can be structured so that it does not provide a "bail-out" to participating carriers or the industry at large. This can be accomplished by requiring that the pricing for the contracts be based on actuarial analysis, and that the base price for the auction reflect average expected annual loss costs, plus a premium to provide a margin of error and cover administrative costs. The market price for the contracts might well be higher than the base price, depending on demand.

2. *Participation Should Be Open To Private Carriers and State Funds*

Federal natural catastrophe legislation should not create incentives for governmental entities to assume risks that can be borne by the private sector. At present, only three states (Florida, Hawaii, and California) have established catastrophe insurance or reinsurance funds. All other states which have considered the creation of such mechanisms have rejected them because they prefer a more private sector approach. In New York, for example, the legislatively created Temporary Panel on Homeowners' Insurance, chaired by Superintendent of Insurance Levin, opposed the creation of a state reinsurance fund because such a fund would "disrupt the New York homeowners' insurance market and significantly increase the cost of insurance for homeowners."

In light of such concerns, AIA believes that the decision to establish a state catastrophe fund should be based entirely on state-specific factors, and not be influenced by a layer of reinsurance protection made available only to states which establish government insurance or reinsurance mechanisms. This is a major concern for us with respect to H.R. 219. Although the bill was amended in Subcommittee to provide federal reinsurance to state programs which would auction coverage to private carriers, the bill still requires unnecessary government involvement at the state level. We prefer an approach that allows both private carriers and state funds to purchase high level excess-of-loss protection from the federal government.

Under such an approach, both private carriers and state funds would be considered eligible purchasers and would participate in the same auction process to obtain protection against catastrophic losses. In this way, the insurance entities (whether private carriers or state funds) with the greatest need for the excess-of-loss contracts would be willing to bid the most for this protection. Although some parties have expressed concern about making sure the process is "fair" to state funds, in fact, these funds would have a competitive advantage over private carriers in bidding for the excess-of-loss contracts since they have a greater concentration of catastrophe exposure in their portfolio and are exempt from taxation on their earned insurance premiums. AIA is not seeking to remove this advantage from state funds which wish to participate in an excess-of-loss auction process, but we do not believe that state funds need to be granted any additional advantages over private carriers who also seek to purchase excess-of-loss protection.

3. *A Federal Program Should Cover only the Most Serious Disasters*

AIA believes that the federal role should be limited to the most serious disasters--those that are simply too large for private insurance, reinsurance, or capital market capacity to handle without insolvencies that would jeopardize the entire insurance system.

There are several reasons why we support a high program trigger. First, a high trigger is consistent with our belief that any catastrophe legislation should maximize the role of the private sector and not put the government at risk for catastrophes that can be

borne by private carriers. Second, a high trigger will not interfere with the development and use of innovative capital market mechanisms that are emerging to supplement traditional insurance and reinsurance coverage. Third, a high trigger decreases the frequency with which federal payments might be required under the terms of the contracts, thus minimizing the likelihood of a short-term funding gap.

At this point, AIA does not wish to recommend a specific program trigger, but we believe that the selection should be made based on a review of past catastrophic events, recent private sector activity (both in the insurance and capital markets), and actuarial projections for future events. H.R. 230 has a $10 billion trigger for residential losses. For both Hurricane Andrew and the Northridge earthquake, the split between residential and commercial insured losses was approximately 65/35 (residential/commercial). Applying such a ratio to H.R. 230's trigger would result in a combined residential/commercial trigger of about $15.5 billion, which is equivalent to the insurance losses caused by Hurricane Andrew. Given the recent growth in the reinsurance and capital markets, we believe that a somewhat higher trigger might now be more appropriate, but H.R. 230 offers a good basis for further discussion.

One issue that has arisen in the legislative debate is whether a high trigger addresses insurance availability concerns, or merely works to protect insurer solvency. Our first response is that insurer solvency is critical to the long-term viability of insurance markets, not only for catastrophe insurance but also for all lines of insurance in all states. Moreover, an excess-of-loss auction program offers a comparative advantage to carriers with a greater concentration of catastrophe exposure because the price of the contracts is not based directly on the purchasing carrier's risks. Finally, we believe that a critical component of a healthy insurance market is a state regulatory environment that allows for adequate, risk-based pricing and appropriate underwriting flexibility. In the absence of market-sensitive state regulatory requirements and procedures, no federal catastrophe insurance or reinsurance program will significantly enhance the availability of coverage in catastrophe-prone areas.

4. *Residential and Commercial Property Should be Covered*

Federal natural disaster legislation should cover both residential and commercial property exposures. While more attention has been focused on the homeowners' insurance issue during the most recent Congressional debates, it is important to recognize that the loss estimates for the most severe disasters (e.g., 250-year or 500-year events) are about the same for commercial and residential property exposures, suggesting comparable solvency concerns. Moreover, homeowners will feel limited relief following a major natural disaster if their residences are restored, but they cannot pay their bills because the businesses which employ them remain in rubble. Nor will local communities benefit if their commercial revenue base is severely impaired as a result of commercial property losses. Any federal legislative solution must lead to rebuilding of the total community--homes and businesses--following a severe catastrophic event.

Commercial property insurance is, however, different in some respects from traditional homeowners insurance. For example, in the commercial arena, a single blanket policy may cover several properties, which may be in different states and exposed to different perils. Moreover, construction type and mitigation measures may greatly influence the maximum probable loss facing two structures of comparable value. A wide variety of deductibles also may be used. Because of this complexity, a direct reinsurance program, particularly one operating on a state-specific level, will be more difficult to implement for commercial lines. However, a national excess-of-loss program based on an industry-wide loss trigger is well suited to commercial property insurance because it does not rely on property-specific information that is impracticable to obtain for commercial lines.

5. *Budget Scoring Should Recognize the Long-term nature of Catastrophe Risk*

The Congressional Budget Office's October 1997 cost estimate of H.R. 230 raised the possibility that a major catastrophe could occur early in the life of the program, before sufficient premiums have accumulated to cover the government's payment obligations under the terms of the excess-of-loss contracts. Such timing issues are at the heart of any insurance transaction, particularly one involving large and infrequent events such as natural disasters.

A simplistic analysis, however, ignores the long-term nature of the catastrophe insurance system. Insurers attempt to spread risk not merely across exposures within the same period but also across many time periods. Although property insurance contracts typically are sold for one-year policy periods, over the long term, there is a high degree of persistence between insurers and their customers. Even if the specific population of policyholders varies somewhat from year to year (due, for example, to new marketing strategies or attrition), most insurers assume a similar portfolio of risks, such that they are sustaining their commitment to bear losses from future events. Moreover, in a number of catastrophe-prone states, legislation or regulations restrict carriers' ability to cancel or non-renew homeowners' policies, contributing further to the durability of insurers' commitments.

Given the long-term nature of the catastrophe insurance system, we hope that the Congress will take a longer term view of the federal budgetary implications of an excess-of-loss program, and not score it based on the possibility of a short-term loss. Should the Committee make changes to the excess-of-loss program in order to address budget scoring requirements, we hope that such changes to not impose costly or inequitable mandates on individual carriers.

6. *A Broad-based Consensus is Essential*

A wide range of constituent groups have an interest in solutions to our nation's natural catastrophe problems. AIA believes that federal natural disaster legislation must address the core, and sometimes conflicting, concerns of the key constituent groups, including populations both inside and outside disaster-prone regions. Over the years, we have reached out to almost every party that has been active in the debate, and we will continue to do so in an effort to reach a broad-based.

Conclusion

AIA commends the Banking Committee for its persistence in seeking solutions to the catastrophe problem. We appreciate the opportunity to work with you in defining the most appropriate role for the federal government in improving our nation's catastrophe insurance system.

EMGARGOED UNTIL 9:30 A.M. EDT
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TREASURY DEPUTY SECRETARY LAWRENCE H. SUMMERS
HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE

Chairman Leach, Representative LaFalce, Representative Lazio, Representative Kennedy, members of the Committee. Thank you for affording me the opportunity to speak with you this morning on the important issue of disaster insurance.

Let me begin by complimenting Representatives Lazio, McCollum, Fazio, and other members of the Committee for the bipartisan leadership they have shown in bringing together concerned interest groups, members of the insurance and reinsurance industries, capital market interests, and state and federal government representatives to discuss this issue. Given the complexity of the issue, and the range of interested parties, the fact that we are here today is a testament not only to the skill, insight, and perseverance of this group, but that of their staffs as well.

Disasters are a matter of grave concern for all: They make no distinctions as to where or whom they strike; they make no pretense of waiting until all who would be affected are fully prepared. Their cost can be astronomical, not only for homeowners, but also for businesses large and small alike, as well as state and local governments. While insurance cannot undo all the costs in human terms, it can provide the foundation for a sound recovery in financial terms. We need to ensure that the insurance foundation is as sound as possible.

My overriding purpose today is to convey to you on behalf of the Administration that we see much promise in the current legislation as a means of addressing many of the problems relating to the availability and price of insurance and reinsurance for disaster risk. We have some concerns with specific provisions of the bill, as I shall outline shortly, but we would hope that continued efforts of the kind that this Committee has sponsored would generate appropriate solutions to these concerns. Moreover, we commit to working with you for the purpose of crafting provisions that would address our concerns. While the resulting legislation would not solve every problem related to Federal policy toward natural disasters, it would, in our view, represent a very constructive step.

1. Diagnosis of the problem

To frame our thinking, let me indicate to you the outlines of the problem as we see it:

- The characteristics of natural disasters make the risk associated with them especially challenging for insurers to handle: they happen only very infrequently, but when they do occur, they can be exceedingly expensive.
- In addition, estimating the losses associated with such an event is extremely difficult. Our models are good, and getting better, but with events this infrequent, it is virtually impossible to gauge their predictive accuracy. This substantially increases the uncertainty faced by both homeowners and insurers.
- As a consequence, prices for disaster reinsurance can be very high, especially if judged in terms of the losses incurred in a typical year. These prices are often quoted in multiples of expected loss; for reinsurance against very low-probability events, these multiples can run in the neighborhood of 4 to 7 times expected losses.
- Not only are prices high, but when a disaster occurs, prices can spike, and availability can be curtailed.

These are the problems that insurers are currently wrestling with. Because of their tremendous capacity for absorbing losses, we view the capital markets, in which disaster risk increasingly can be bought and sold like any other security, as a crucial complement to the traditional reinsurance industry. We have closely monitored the rapid development of capital markets and believe that they should provide for well-functioning markets in the long run. But they remain today in a relatively early stage of development. Clearly, a serious problem remains in the interim.

Indeed, while in the last several years our nation has not experienced what is called a "major occurrence" in the insurance industry, the ravages of Hurricanes Iniki and Andrew, and the Northridge Earthquake are all too recent reminders of the potential scale and scope of possible destruction. These events form the backdrop for our efforts today. We are working today in the knowledge that calamities of almost unimaginable scale do occur; we are also working in the knowledge that a policy we adopt out of the current deliberative process will likely better serve the public interest than a policy that we adopt in the immediate aftermath of another such event.

2. Rationale for Federal involvement

In this context, the rationale for Federal involvement in this market rests on three key considerations:

- First, the Federal government is uniquely capable of spreading risk *across the population*. When a private sector insurance company absorbs risks, it can only pass them on to its stockholders and reinsurers. By contrast, when the Federal government absorbs risks, it can pass them on to the entire population of taxpayers -- clearly a much broader base than is available to any private sector entity.

- Second, the Federal government is uniquely capable of spreading risk *over time*. Private insurers can absorb part of a loss by issuing debt, but there is a limit. In the jargon of economics, a private insurer is said to suffer from "timing risk," which is to say that it can only lose so much money in any given period without being declared bankrupt. By contrast, the capacity of the Federal government to borrow for the purpose of meeting short-term contingencies dwarfs that of any private sector entity.
- Third, the Federal government would likely be saddled with part of the cost associated with a truly cataclysmic event, regardless of the outcome of this deliberative process. Therefore, to some extent, the decision here can be viewed as determining whether the Federal liability will be explicit and deliberate, or implicit and indirect.

Taken together, these considerations constitute a strong case for prudent participation of the Federal government in the market for disaster reinsurance. Lest I be misunderstood, we see this as a case for *limited* participation for a limited time: It is a case for making hardheaded investments on behalf of taxpayers, absorbing risks at a price that provides fair compensation to taxpayers. And it is a case for making those investments for a limited time only, until the private market can mature. Finally, it is a case that argues for exploiting the fiscal capacity of the Federal government in a way that does not jeopardize that capacity.

3. Where we are today

In framing our current thinking on this topic, we have found it useful to enumerate a set of common-sense principles. Specifically, we believe that:

- the government should provide disaster insurance when its ability to spread risk across the population and over time would allow it to do so temporarily on substantially more favorable terms than the private market;
- the government should provide disaster insurance in a manner that avoids imposing a net cost on the taxpayer;
- the government should provide disaster insurance in a way that harnesses existing market forces to the maximum extent, and encourages their further development in the future; and
- the government should be prepared to put itself out of the business of providing disaster insurance, making way for a strengthened private market to take over.

Adhering to these principles will limit the risk that a program of this type could impose on taxpayers. Because the potential liability in this market is so enormous, we must design the Federal role with the same kind of hardheaded fiscal prudence that has been so important in achieving a balanced budget. Adhering to these principles will also ensure that government participation in this market supports private structures rather than supplanting them. Ultimately, private capital markets should be able to diversify this risk as well as or even better than the Federal government. But clearly, the capability of those markets to perform that task will never emerge if government participation is not carefully delimited. We believe that a middle way exists: one that meets the interim need, while preserving adequate incentives for market

development for the longer term.

Let me be clear: we believe that HR 219 provides a foundation that could, with suitable modifications, be made consistent with these principles.

In the remainder of my remarks, I will be focussing on HR 219 because that is the legislation before the Committee. However, I should like to make clear that I do not want to preclude other approaches to addressing the problem of disaster insurance. In particular, we still view an industry excess-of-loss contract as a potentially valuable way of providing disaster reinsurance to a broader class of counterparties than state funds. Indeed, we should certainly avoid sending the message with this legislation that, in order to reap the benefits of Federal reinsurance, a state must establish a centralized fund or auction program. An approach that seems promising to us is one that would, in effect, marry the best ideas of HR 219 and HR 230, by offering not only reinsurance to state funds, but also excess-of-loss contracts on similar terms to an unlimited class of buyers, possibly by means of an auction. We think it would be a substantial improvement to the current legislation to ensure that the playing field is kept level, as between state programs and other potential customers of disaster reinsurance.

4. The legislation at hand

Let me now turn to the specifics of the legislation before you. In essence, HR 219 would have the Federal government provide reinsurance to qualifying state funds and auctions for losses incurred on residential policies within the state. It would establish a trust fund that would receive all premium income and the proceeds of any borrowing done on the program's behalf, and would dispense payments in the event of qualifying disasters. In the event that some borrowing is required, the legislation would require every state program participating at the time to continue purchasing reinsurance at no less than the prior level until the borrowing is repaid. The legislation would also establish a Commission for the purpose of advising the Secretary of the Treasury as to the appropriate price for the insurance.

In our view, this legislation represents a constructive and creative response to a serious situation, namely, the difficulty faced by state funds (notably the California Earthquake Authority and the Florida Hurricane Catastrophe Fund) in purchasing extensive reinsurance against low-probability risks, either because the reinsurance is simply unavailable or because premiums are high. We welcome this response, and applaud the efforts of all those who have worked so hard to bring it to this stage.

That said, we do have some concerns about this legislation. But let me be clear: while we view these concerns as important, we would hope that continued efforts of the kind that this Committee has sponsored would generate appropriate solutions.

Chief among these concerns is that the pricing decision be sufficiently insulated from political pressures as to remain objective. In order to buttress the integrity of the pricing process, we suggest that the Secretary of the Treasury be allowed to adjust the Commission's estimate of expected loss upward, but not downward. We also suggest that the language of the legislation be clarified as to the factors that the Secretary should take into account in setting the "risk load" in the price of the reinsurance contracts.

In addition, as I indicated before, we believe the legislation should be modified to provide for the sale of excess-of-loss contracts to all entities on an unrestricted basis. Our objective is to improve the availability of disaster reinsurance, not to favor state programs over other possible vehicles for delivery of insurance to homeowners. Indeed, it might be possible to devise an auction mechanism for the distribution of these contracts; this would have the virtue of ensuring that competition plays a role in setting the price of the contracts, and channeling them to those who see the greatest value in them.

We believe that the scope of the Federal program should be limited, in order to preserve adequate incentive for the further development of the private market. Specifically, we suggest that the Federal program be sunsetted after some fixed number of years; that the Federal program be authorized to underwrite no more than some specified fraction of the risk faced by any given state fund; and that provision be made for periodic review of the trigger points in light of the ongoing development of private markets. In all these respects, the goal should be to ensure that the Federal program supports rather than supplants the private market.

We also suggest that you consider reengineering several aspects of the design of the contracts in ways that might make them more useful to the state funds. Specifically, we suggest that you consider covering multiple perils rather than a single peril. We suggest that you carefully consider how best to limit the Federal liability under this program. The current legislation proposes a cap on aggregate payout; it strikes us as possible that some other mechanism might be preferable. For example, a simple limitation on the amount of insurance that any particular state fund could purchase might serve the same objective, without causing the value of the insurance to each state to depend on the actions of all other states. We also suggest that the state funds *not* be compelled to continue as purchasers of reinsurance in the event that borrowing is required to make good on some other state's contracts. And we suggest that eligibility for the Federal program not be contingent on the state program's using a specified fraction of its investment earnings for mitigation.

I have attached as an Appendix a staff document that lists a number of technical questions regarding the legislation in greater detail.

The budgetary treatment of this legislation is a complex and highly technical topic, and my purpose today is not to explore those issues with you, not least because, as many of you know, these are not settled issues. Nonetheless, it would be our hope, first, that the legislation could be reworked along the lines we have suggested, and second, that we could accomplish our goals without burden to the taxpayers, or adverse impact on the deficit. I look forward to working with you to preserve the integrity of the pricing that is envisioned in the current language.

While the list may seem long, all of our suggestions derive from our two core concerns, that relief for affected homeowners not come at the expense of taxpayers, and that any federal program support, rather than supplant, private markets. We look forward to working with Members of this Committee, its staff, representatives of industry, of affected communities and with other stakeholders to resolve these issues.

5. Conclusion

From the beginning, the Clinton Administration has recognized the urgency of improving the nation's ability to deal with natural disasters. Indeed, our initial efforts on this issue culminated in a February 1995 Administration Policy paper, "Natural Disaster Insurance and Related Issues." In that paper, as you know, we supported the idea that the Federal government should issue excess-of-loss contracts as a means of fostering liquidity in the market for disaster insurance. We also strongly supported a comprehensive approach, including among other elements, measures to ensure that cost-effective mitigation is undertaken. We still believe in the wisdom of a comprehensive solution, and reaffirm the importance we attach to prudent and appropriate mitigation. However, further study has made clear to us the impracticality of achieving all of our objectives in one Federal program.

Progress on this issue has been too long in coming. We believe that we all share a clear recognition of the urgent need for moving forward on a timely basis. In particular, we will certainly be well served if we have a sensible and constructive structure in place before the next major disaster strikes. Surely, the time to build a better roof is when the sun is shining. The current legislation provides a sound foundation for progress in this area, and I look forward to working with you to improve the legislation.

Appendix

Technical Questions about HR 219

This appendix lists a number of concerns about the current legislation, and advances some ideas for addressing them.

- In the letter of invitation, you asked for comments on whether it would be useful, in terms of insulating the pricing decision from political pressures, to limit the Secretary's discretion in deviating from the recommendation of the Commission regarding expected cost. We believe that such a limitation would be helpful; we recommend that the Secretary be given one-sided discretion, to move the estimate of expected cost up from the Commission's estimate, but not down.
- An additional salutary feature of the current language in the bill is that the Secretary is given discretion to increase the "risk load" component of the price upward from 1 times expected cost. It would be helpful if the legislation specified that, in making this determination, the Secretary's objective should be to provide taxpayers with fair compensation for the risk they bearing, and that the factors he takes into account should include the stage of development of empirical models of natural disasters, and the state of private markets, among other factors.
- The budgetary impact of this program is critical. It is extremely important that the proceeds from the sale of Federal disaster insurance not be spent or otherwise dissipated. If these proceeds were spent, and then a covered event were to occur with an associated payout from the Federal government, the pressure on the fisc would be greater with this program than without. How best to prevent this from happening is a difficult question. The present language in the legislation proposes the creation of a Disaster Reinsurance Fund, for the purpose of accumulating premium payments and disbursing payouts in the event a covered disaster occurs. A Fund of this type has the virtue of suggesting that the revenues from the program should not be diverted to other purposes, and that the program should be viewed as operating on a self-financing basis. However, it has the potential shortcoming that the balance in the Fund at any given time could easily provide a misleading signal as to the adequacy of pricing. If a calamity were to occur in the early years of the program, the Fund would run a negative balance for a very long time (financed by Treasury borrowing), and the temptation would be to conclude that premium rates had been set too low. On the other hand, if -- as is hoped -- no covered event occurs for a period of some years, the balance in the Fund will accumulate to a substantial sum, and some will question the need for continuing to levy additional premiums "simply" for the sake of building up the balance in the Fund further. The desirability of a Disaster Reinsurance Fund is an open question, and the relative pluses and minuses must be weighed from the perspective of maximally ensuring the integrity of pricing.
- As for the form of the insurance, one option would be to authorize the Federal government to provide aggregate coverage for more than one event occurring within a 12-month period, rather than just a single event. Discussions with various market

participants suggest that a great deal of concern revolves around the availability of coverage for a second event.

- Careful consideration should be given to the question of whether Federal liability should be capped at $25 billion per year across all insured programs. A disadvantage of this approach is that it would cause the value of the reinsurance to any given State to depend on the decisions of other States. An alternative approach would be to limit the amount of reinsurance that any given State program can purchase.
- On a related point, the legislation as currently written specifies that *all* State programs with reinsurance in force at the time that any borrowing is undertaken on behalf of the Federal program would be required to continue purchasing reinsurance at no less a level until the debt is fully paid off. It may be preferable to omit this requirement. Imposition of this requirement would substantially complicate the decision of any given State program as to whether it should participate in the Federal program, and could lead to divisive controversies regarding transfers of resources across States.
- With regard to the Commission, it may be advisable to augment its membership to include experts from the world of finance and economics, since knowledge of those fields will certainly be germane to the pricing decision.
- With regard to the eligibility requirements for state programs, it may be desirable not to require these programs to commit a specified percentage of their investment earnings toward mitigation. States should engage in all cost-effective mitigation and no more, and it is not clear that linking the mitigation decision to an arbitrarily specified fraction of net investment earnings would advance this objective. Similarly, the pricing decision by State programs should be tied to actuarial risk, and it is not clear that creating a requirement to fund mitigation advances that objective.
- The Committee should consider augmenting the legislation with a number of measures designed to preserve incentives for the development of a parallel market for disaster risk in the private sector. Specifically, the program could be hardwired to sunset after some fixed period of time, perhaps 10 years; in light of the rapid pace of development of private capital markets, this should provide ample time for alternative mechanisms to develop that will allow State programs to lay off their risks efficiently.
- The Federal program should be authorized to underwrite no more than some specified fraction of the risk in excess of the trigger faced by each participating State fund, perhaps 50 percent. Even with a limitation of this type, the Federal commitment would be very substantial relative to the volumes currently being transacted in private markets, and the resulting program would still leave an incentive for private market development even while the Federal program is in operation. Provision should also be made for periodic review of the trigger points in light of the ongoing development of private markets.

TESTIMONY OF DONALD A. DOWDELL, DEPUTY GENERAL COUNSEL, FLORIDA DEPARTMENT OF INSURANCE, BEFORE THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY, THURSDAY, APRIL 23, 1998.

Good morning, my name is Donald Dowdell. I am Deputy General Counsel for the Florida Department of Insurance.

Florida's experience with Hurricane Andrew, the most costly natural disaster in American history, has provided two important lessons. First, insurance companies, individual citizens, and the state must all take responsible action to prepare for the immense costs of a major natural disaster. Second, in a worst case scenario, a high intensity natural disaster, hitting an area of dense development, can inflict more damage than a state, even a state with Florida's financial resources, can bear on its own.

Hurricane Andrew was a Class 4 hurricane on the Saffir-Simpson scale. It is generally viewed as a one in fifty year storm in terms of frequency of occurrence. Insured losses from Hurricane Andrew in Florida were $16 billion. Eleven insurance companies became insolvent as a result of Andrew claims. After twenty years without a major hurricane in Florida, and high profitability, numerous insurance companies had grown complacent to the hurricane risk in Florida. Hungry for market share, they became seriously overexposed to hurricane risk, particularly in South Florida. As a result of this overexposure, both State Farm Fire and Casualty Company and Prudential Property and Casualty

Insurance Company had to be rescued by their parent companies from insolvency from Andrew claims.

The shock of Andrew claims and risk of further claims from overexposure to hurricane risk created an environment in Florida where massive cancellations of homeowners policies and retreat from the state by insurance companies were at hand. Consequently, a moratorium on cancellation and nonrenewal of residential property policies was enacted by the Florida Legislature to stabilize the market and allow for an orderly adjustment to exposure problems. The moratorium has been enacted in three phases, and the final phase concludes in November, 1999. Under the moratorium, in any twelve month period, an insurer cannot cancel or nonrenew, for reason of hurricane risk, more than 5 percent of its residential property policies statewide or 10 percent of its residential property policies in any one county. The insurer is also allowed to cancel or nonrenew policies under its underwriting rules for any reason other than hurricane risk.

Even with the moratorium in place, a legislatively created market of last resort for residential property insurance, the Florida Residential Property and Casualty Joint Underwriting Association (JUA), was necessary to serve consumers who were unable to obtain homeowners insurance coverage in the private insurance market. The JUA was created in November, 1992, and by

September, 1996, had grown to 937,000 policies. Since that time, there has been aggressive effort to depopulate this facility and find private insurance for these consumers. The JUA currently is down to approximately 339,000 policyholders. Of these 339,000 policyholders, approximately 261,000 are in Dade, Broward and Palm Beach Counties in southeast Florida.

In addition to the JUA, Florida has a coastal wind and hurricane insurance facility, similar to facilities in other coastal states, called the Florida Windstorm Underwriting Association. This facility covers wind and hurricane perils in designated coastal areas where wind and hurricane coverage have been determined by public hearings to be unavailable in the private insurance market. At the time of Hurricane Andrew, the Windstorm Association had 62,000 policyholders. Today, it has 447,939 policyholders. While the JUA was created as a temporary mechanism to address market disruption after Andrew, the Windstorm Association is designed to be a permanent insurance mechanism for high risk areas. Thus, the Residential JUA and the Windstorm Association have a total of approximately 787,000 policyholders whose hurricane coverage is with a legislatively created residual market mechanism. This number of policies being written in legislatively created insurance mechanisms of last resort is indicative that Florida's property insurance market has not fully recovered, and that in the longer term, absent an

ability to spread the risk of loss from catastrophic hurricanes, the private insurance market may not be able or willing to cover the most high risk areas of Florida.

Florida continues to aggressively take action to reduce the residual market population and restore the private homeowners market.

Florida has encouraged hurricane loss mitigation by mandating homeowners insurance premium discounts for hurricane shutters and other wind protective devices and by permitting insurers to utilize a rating factor providing a rate credit or surcharge based on effectiveness of building code enforcement by the local government where the insured property is located.

Steps have also been taken with regard to preparing financially for the next catastrophic hurricane. Florida has created the Florida Hurricane Catastrophe Fund, a one-of-a-kind state facility which accumulates funds on a tax-exempt basis to act as reinsurance, reimbursing insurers if hurricane losses reach a threshold level.

Established in 1993, the Catastrophe Fund has already accumulated approximately $2 billion in cash and has an additional $8.5 billion in bonding capacity. The bonding capacity of the CAT Fund was enhanced by an Internal Revenue Service private letter ruling to the CAT Fund last week, finding that the CAT Fund can issue tax exempt bonds. Thus, the

Catastrophe Fund, as of the end of this year, will have the capacity to reimburse insurers $10.78 billion, which is approximately 67% of the insured losses in Andrew. The Catastrophe Fund receives its funding through premiums charged to property insurers writing in Florida, and insurers may participate in the Catastrophe Fund at varying levels above the reimbursement threshold, depending on their reinsurance needs. A property insurer may elect a 45%, 75%, or 90% reimbursement level, and pay a premium for that level, but must participate in the Catastrophe Fund at some level. By law, insurers may pass their Catastrophe Fund premiums directly on to their Florida policyholders.

The availability of reinsurance coverage from the Florida CAT Fund has enabled insurers to spread the risk of loss of average hurricane exposures and as a result insurers are beginning to write coverage on a limited basis. Without the CAT Fund we would not have been able to reduce the population of the Residential Property Joint Underwriting Association. However, despite the success of the CAT Fund, as a practical matter, everything we have done is inadequate to respond to a one hundred year storm or successive less catastrophic storms.

The Residential JUA and Windstorm Underwriting Association have both made financing arrangements to assure that funds will be available to promptly pay claims in the event of a major

hurricane. The Residential JUA has secured a $1.5 billion line of credit and $500 million of pre-event bonds to pay claims when needed. The JUA's estimated probable maximum loss from a one in one hundred year hurricane is $2.75 billion. The Windstorm Underwriting Association has a $1.5 billion line of credit and currently is arranging a line of credit up to $2 billion and $500-800 million of pre-event bonds. The Windstorm Association's estimated probable maximum loss from a one in one hundred year hurricane is $4.8 billion. Both of these probable maximum loss estimations contemplate a landfall in Dade or Broward counties. Should these financing arrangements be drawn to pay claims for a major hurricane, the funding must be repaid to the lenders through assessments to all Florida property insurance policyholders. This is where a "second storm" problem arises. If available funds are drawn to pay claims from "storm one," the Residential JUA and Windstorm Underwriting Association would have to go back to the capital markets and attempt to seek new financing for the next storm, "storm two." In this scenario, a second assessment would have to be stacked on the first assessment to secure repayment of both financings. However, there is a limit to how much assessment Florida citizens can absorb if the costs of multiple storms have to be financed.

This scenario points out one of the most difficult aspects of stabilizing Florida's property insurance market. Florida is

making good progress getting over the effects of Andrew. We are making good progress preparing to pay for the next major hurricane. However, there is a finite amount of funds which can be secured from private insurance and reinsurance capacity, Florida Hurricane Catastrophe Fund reimbursements, capital market financing and policyholder assessments. While there are statistical predictions on the highest magnitude storm which should occur once every 50 years, 100 years, 500 years and so on, the "big one" could hit during any hurricane season or, just as problematic, multiple major hurricanes could strike back-to-back. This isn't statistically likely, but no one can say for sure it won't happen.

Thus, Florida is faced every hurricane season with the possibility of a worst case scenario: a Class 5 hurricane striking somewhere between downtown Miami and downtown Ft. Lauderdale. This hurricane is estimated to produce damage of $53 billion. At the present time, there simply isn't $53 billion in capacity in Florida's property insurance structure. Florida simply cannot handle a natural disaster of this magnitude on its own. Moreover, as Florida continues to rapidly grow, the areas with high density development creating a worst case scenario will continue to expand. What would have been only a high intensity hurricane fifty years ago becomes a major natural disaster when

the area that was pine forest fifty years ago is now dense, high value development.

Florida is not alone in worst case disaster scenarios which would likely be more than an individual state could handle. A Class 5 hurricane striking the Hampton/Virginia Beach area is estimated to inflict $33.5 billion in damages. A Class 5 hurricane striking New Orleans is estimated to inflict $25.6 billion in damages. A Class 4 hurricane striking Asbury Park, New Jersey, is estimated to inflict $52 billion in damages. A Class 4 hurricane striking Long Island, New York, is estimated to inflict $45 billion in damages. A Class 5 hurricane striking Galveston, Texas and moving inland is estimated to inflict $42.5 billion in damages. A Class 4 hurricane striking Honolulu is estimated to inflict $30 billion in damages. A 7.5 level earthquake in Seattle is estimated to inflict $33.3 billion in damages. A 7.0 level earthquake in Los Angeles is estimated to inflict $57.7 billion in damages. An 8.6 level earthquake on the New Madrid fault in Memphis is estimated to inflict $69.7 billion in damages. An 8.2 earthquake in San Francisco is estimated to inflict $84.4 billion in damages.

In the immediate aftermath of Hurricane Andrew, numerous Federal agencies, including FEMA and the National Guard, provided relief and assistance in a time of critical need. For this we will always be grateful. However, it is becoming increasingly

clear that Federal assistance is needed in the aftermath of a major natural disaster for more than emergency food and shelter.

If the "Big One" strikes, there is no question that Federal assistance will be needed to back up the affected state financially. If a community cannot rebuild in a reasonable period after a natural disaster due to lack of funds, it can suffer irreparable economic harm. Therefore, from Florida's perspective, it would be most beneficial to establish the role of private insurers, individual states, and the Federal government now before the need actually exists rather than in an emergency situation.

We strongly support an approach such as that envisioned by HR 219 and are confident that the Florida Catastrophe Fund can effectively co-ordinate with the federal program established by this legislation. Thank you for your consideration of this important issue and for this opportunity to provide testimony.

STATE OF CALIFORNIA CHUCK QUACKENBUSH, *Insurance Commissioner*

DEPARTMENT OF INSURANCE

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Date: April 21, 1998

To: U.S. House of Representatives
Committee on Banking and Financial Services

From: California Department of Insurance; Legislative Bureau

Subject: H.R. 219--Homeowners' Insurance Availability Act of 1997

The California Department of Insurance is pleased to support H.R. 219 which would allow the Secretary of Treasury to provide a federal reinsurance program via reinsurance contracts to eligible state insurance programs.

California has a deserved reputation as being vulnerable to the vicissitudes of natural disasters: particularly earthquakes. In 1994 an earthquake measuring 6.8 on the Richter Scale wiped out major portions of the city of Northridge. It soon became clear in the aftermath of the quake that there was a fundamental flaw in the manner in which earthquake insurance had been priced. Farmers Insurance, for example, ended up paying out more in claims than it had collected in the previous twenty-five years in premiums. Twentieth Century took out a $100,000,000 reinsurance policy, prior to the Northridge event based upon a one time loss expectancy of an 8.0 earthquake, and wound up paying out over ten times that amount, barely surviving the grievously

looming threat of insolvency. These two examples were quite representative of the shift in the market at the time which threatened the solvency of dozens of homeowners' carriers in the state. Instead of acquiescing to pressure to continue to offer earthquake insurance which homeowners' carriers licensed to do business in California were statutorily compelled to do, the industry sought legislation to relieve them of this responsibility. This generated a dynamic bifurcation between the threats of insolvency to the property insurance industry and the needs of the consumers of California to maintain continuous and unmitigated earthquake coverage.

In 1995 Assemblyman Knowles, now Chief Deputy Commissioner of the Department of Insurance in California, authored a pioneering work (AB 1366) in the area of earthquake insurance reform credited with averting potential post-earthquake insolvencies. This piece of legislation, coupled with steadfast cooperation between the state legislature and California Department of Insurance, paved the way for the creation of the California Earthquake Authority (CEA) in 1996 which successfully resolved the earthquake insurance availability crisis by radically creating a core paradigm shift in both the expectations and manner in which pricing was conducted.

The CEA represents an effective partnership between government and the private sector. No public monies are earmarked to cover potential losses, instead its claims paying capacity, which now is an estimated $7.4 billion, is derived from premiums, insurance carriers and private sector reinsurance contracts.

The methodology used to determine the loss expectancy of a one in 250 year catastrophic earthquake indicates an approximate $3.5 billion dollar loss to the CEA.

Given accurate actuarial data, it is evident that two such events within a brief period of time, could completely deplete the available claims paying capacity of the CEA, including all existing private sector reinsurance purchased by the CEA. While it is highly unlikely that two 250 year events, each over twice as financially damaging as the Northridge quake, could occur in relative succession, it is prudent to support the potential purchase of a federally backed reinsurance product, unavailable in the private sector, that could boost the claims paying capacity of the CEA to approximately $25 billion.

R.H. 219 provides for the development of a federal reinsurance safety-net to provide additional property disaster insurance availability to eligible state insurance programs, state reinsurance programs or state auction programs for residential property losses to homes, condominiums, cooperatives and contents of apartment buildings caused by earthquakes, fires and tsunami resulting from earthquakes, and tropical cyclones (including typhoons and hurricanes). A federal backstop for participating state programs would go a long way toward alleviating the inherent uncertainty of a series of catastrophic natural disasters. Furthermore an existing, affordable federal reinsurance safety net would serve as a genuine incentive for non-eligible states to create eligible programs which could ultimately opt into the federal program, thusly better serving their residential insurance policy holders.

Consideration should be given to private reinsurers as the existing market mechanisms fostering competition at the state level have enabled the CEA to increase it claims paying capacity by approximately $2.5 billion. The private sector however,

simply cannot provide a product to compete with the federal model in either magnitude or cost. The estimated $17.6 billion in federal property reinsurance at a projected cost of approximately $15 million is both secure and more inexpensive than the current market rate for similar risk exposure, which is about 14%. This is not to suggest that the federal reinsurance program proferred in H.R. 219 would in any way supplant current levels of reinsurance purchased by the CEA but would instead augment it. The California Department of Insurance in no way doubts the inherent ability of market forces to remedy, in the long term, insurance unavailability in the wake of natural disasters. Currently about 70% of earthquake insurers have enrolled in the CEA. This has encouraged those carriers to return to the basic homeowners' market, infuse it with the necessary capital to keep the cost of premiums down and increase the availability of basic homeowners' policies.

While the California Department of Insurance supports H.R. 219, we believe it can be improved upon by ameliorating a few concerns. There seems to be an incompatibility issue regarding fire coverage, which is generally covered in a standard homeowner's insurance policy but is not a part of the CEA policies. The federal proposal includes fire coverage, potentially encouraging private carriers to phase-out this coverage if it is believed that it is now covered by the federal reinsurance pool. Current language in H.R. 219 limits the resolution of claims to 3 years. However, empirical evidence suggests that more time may be needed under certain circumstances; for example many claims are still open from the 1994 Northridge earthquake. If a loss in a participating state exceeds the available capital in the reinsurance pool, California would still be

required to continue to purchase coverage in the same amount until the bonded indebtedness is retired, potentially causing a marked increase in private reinsurance rates. This provision could be viewed as penalizing states that would then have reduced coverage in order to establish an actuarially sound federal pool. The provision on Reinsurance Retention (8) appears to lock current state pools into their current claims paying capacity, whether adequate or not. While it seems appropriate not to encourage state pools to cancel private market contracts in favor of federal reinsurance, it is equally burdensome to state pools to have their hands tied in reinsurance renewal negotiations. If it is clear in the private market that a state pool must maintain its current claims paying capacity, the price of those state pools may linger at artificially high levels. Moreover, it is unclear if, after a loss, the federal reinsurance would drop down to the new capacity of the pool or, if a state pool would be ineligible for coverage until it replaced the claims paying capacity it possessed upon establishment of the federal program. It is also unclear what would happen if a pool experiences two relatively concurrent losses in the same calendar year. Would the federal reinsurance drop down to attach at the current claims paying capacity or would the coverage be only occurrence based, thereby creating a "gap" in coverage when it would be needed most. The attachment point (current claims paying capacity) ought to be elastic not rigid, to allow for subsequent incurred losses to be subtracted from current claims paying capacity. This would allow the reinsurance to kick-in after a series of devastating natural disasters in California rather than providing benefits only after a single catastrophe of unimaginable proportions. As written, the bill may inadvertantly punish the state fund

which currently has the highest claims paying capacity.

H.R. 219 is an important piece of legislation as it provides a federal reinsuance pool to allay the concerns of enormous financial liability in the case of a single catastrophic or series of catastrophic natural disasters to those eligible states without raising insureds' premiums significantly. This product fills a niche that cannot adequately be provided for less expensively in the private sector, nor does it curtail the activity and infusion of investment capital into the private market.

H.R. 219 protects the consumers of California by further protecting them against catastrophic loss of their most valuable possession; their homes.

Testimony
Kevin T. Campion
Senior Vice-President
Paragon Reinsurance Risk Management Services, Inc.
Before the U.S. House of Representatives Banking and Financial Services Committee
April 23, 1998

Introduction

Good morning, my name is Kevin T. Campion. I am a Senior Vice-President with Paragon Reinsurance Risk Management Services, Inc., in Minneapolis, Minnesota. Paragon is a wholly owned subsidiary of E. W. Blanch Holdings, Inc., a leading provider of integrated risk management services. My roles with E. W. Blanch include leading Paragon's efforts for the Florida Hurricane Catastrophe Fund, for which we provide administrative and actuarial consulting services. I have also been involved in the placement of reinsurance for residual market entities such as the Florida Windstorm Underwriting Association and the Mississippi Windstorm Underwriting Association, for the state-run California Earthquake Authority (CEA), and for traditional insurance companies.

The Homeowners' Insurance Availability Act of 1997, H.R. 219, would create Federal reinsurance for state disaster programs or auctions. This self-funded facility would protect these programs against relatively rare but extremely damaging natural disasters, primarily earthquakes and hurricanes. Paragon was asked by the Subcommittee on Housing and Community Opportunity to assess whether the structure envisioned in H.R. 219 was feasible and financially sound. I am here to testify on current state disaster programs, the use of computer models to evaluate catastrophic risk to insured properties, and on the results of our analysis of H.R. 219.

Current State Programs

Let me begin by briefly assessing the performance of the existing state programs. Currently, there are three, in Florida, California and Hawaii.

Florida

The Florida Hurricane Catastrophe Fund (FHCF) was created in 1994 in response to the market dislocation in Florida after Hurricane Andrew. The FHCF is a mandatory, federally tax-exempt reinsurance program for companies writing residential insurance in the state and covers every insured residential property. No tax dollars are used to support it. Since its inception there have been 600,000 policies moved from the residual market to the private market. The major factor enabling this transfer has been the additional reinsurance capacity provided by the FHCF. The Cat Fund has a provision that allows insurance companies to select participation levels, and the average of those levels has been steadily rising, which is indicative of the success of the program. The Fund has sufficient capacity today to cover a loss larger than Andrew in size.

California

The California Earthquake Authority is the largest insurer of residential earthquake risks in the world. It is also tax-exempt. Seventy percent of the admitted homeowners insurance market in the state participates in the fund. It is financially secure, and has arrived at this position purely through private capital contributed outright or contingently. No tax dollars support it. As a result of the CEA, the homeowners

insurance market in California has recovered from the effects of the Northridge earthquake. Today it has sufficient claims-paying capacity to cover an event two and one-half times the size of Northridge. Prior to the CEA in July 1996, 98% of the market had severely restricted or stopped selling new homeowners policies. By December 1997, after the CEA had been created, 97% of the 110 writers in the state said they had no restricted underwriting criteria.

Hawaii

As with California and Florida, Hawaii created a state program after Hurricane Iniki struck in the fall of 1992 and the homeowners insurance market in the state collapsed. The Hawaii Hurricane Relief Fund is also a tax-exempt, primary insurance facility run by the state. Its claims-paying capacity could cover another Iniki.

Description of the Legislation

Now that we have taken a look at the state funds, let me describe what H.R. 219 would do. It would create a Federal reinsurance "backstop" above these and other state disaster programs and auctions. It would provide a layer of reinsurance above what state insurance programs like the CEA and the Hawaii Hurricane Relief Fund, and state reinsurance programs like the FHCF, currently provide. The bill also provides states with the opportunity to auction Federal reinsurance directly to insurers and reinsurers within the state. Federal reinsurance coverage would not begin for any state until insured residential losses exceeded that state's retention.

Premiums collected from each state program would be actuarially-based. They would be set by the new National Commission on Catastrophe Risks and Insurance Loss Costs, and would be at least two times the state's average annual expected loss, plus expenses. The Loss Costs Commission would also set an actuarially-determined reserve, or minimum, price for reinsurance sold through the state auctions.

Auction Illustration

Let me illustrate how the auction might work with a hypothetical example. Suppose South Carolina creates a state-operated auction program. Let's assume the Loss Commission determines that South Carolina must pay $200 million for $25 billion in Federal coverage. South Carolina might auction the total limit as 10 separate contracts, each for 1/10th of the total limit. If the state collects more than $200 million for these contracts, then 90% of that excess goes to the Federal Disaster Fund and 10% is retained by the state for loss mitigation purposes. Of course, the initial $200 million also goes into the Federal Disaster Fund.

If a hurricane strikes South Carolina and causes covered residential losses totaling $1 billion more than the state's retention, then each of these contracts would be worth 1/10th of $1 billion (since 10 contracts were sold), or $100 million. A company owning one of them would receive $100 million if they had insured losses of at least $100 million.

For both the backstop over state programs and the auction, Federal liability is capped at $25 billion per year after a four-year phase-in period. There is also a provision that if due to losses in prior years the program is running at a deficit, the limit available

in subsequent years will not exceed what can be paid off by the program's premiums within twenty years. In short, the legislation has been designed to collect more money than it should pay out, and limits Federal liability if a series of inopportune events occur.

Pricing and Operational Questions

Could there be inadequate pricing of such coverage? It would be the responsibility of the Loss Costs Commission to ensure that rates are actuarially sound. I believe that catastrophe models available today could be effectively used to develop adequate rates, especially when a risk load equal to the risk-based price is added. Average losses could then be twice as large or frequent as the modeling suggests and the premium would still be adequate. Later in this testimony I will discuss the results of simulations of this bill which also support this claim.

Is such a program operationally feasible? Already three states representing almost 20% of the total U.S. population, including the two states with by far the largest exposure to natural disaster, have successful state programs. Our experience in dealing with them would suggest that though issues may arise they can be successfully resolved.

Use of Computer Models to Assess these Risks

Knowing that there is a potential for large losses, insurers and reinsurers need a way to assess their magnitude and likelihood, both in order to fairly price their product and to determine their own risk of solvency. Catastrophe models have been developed to meet this need, and E.W. Blanch Co. has been at the forefront of many efforts in this area. In 1987 we released the CATALYST® wind model, which was the first

probabilistic hurricane model designed primarily for the insurance industry. The model was co-developed with Karen Clark, currently President of Applied Insurance Research (AIR). In 1991 we worked with Risk Management Solutions, Inc. (RMS) to develop their hurricane model. In 1995 we began the development of our own hurricane and earthquake model, CATALYST® 3.0, which will be released in July 1998.

Computer models are employed on a daily basis by the insurance industry to assess the potential for risk. My company places property catastrophe reinsurance for about 100 companies a year, and every treaty of any major size is only placed after a thorough review of exposures and loss potential using at least one of the major catastrophe models.

There are three parts to any such model. The first is the collection of potential events and the meteorological and seismic descriptions of these. A simulated hurricane, for example, is specified by a storm track and the most important meteorological characteristics of the storm along this path. Examples of these characteristics are its forward velocity, central pressure differential,[1] and radius of maximum winds. For an earthquake they are the type of fault involved,[2] the segment of the fault which ruptures, and the magnitude of this rupture. For both earthquake and hurricane events, the models estimate the probability of each event occurring during a year.

The second part of a catastrophe model is a database of the properties that could be damaged by the event. Typically this is a detailed database that includes, among other things, the property and contents values, the materials used to construct the building, and the deductible and policy limit of the insurance on the structure.

The final part of such a model estimates the total damage to properties based on their location and type of construction and on the characteristics of the simulated earthquake or hurricane, and then applies the insurance coverages, policy limits and deductibles to arrive at the insured losses to each structure. These are aggregated to produce industry loss totals for each event.

Catastrophe models are by no means perfect, but they are the best tools we have for estimating expected annual losses in the insurance industry. Models are not intended to estimate damage to a particular structure for a single event, but instead average damage from many events. By averaging anticipated damages over thousands of structures, models can reasonably estimate the effects of an individual storm or earthquake. And for the purposes of determining reinsurance rates for a program such as H.R. 219, what is needed is not the anticipated damage caused by a particular event, but rather the expected annual loss to a state caused by all possible events. Because we are finally looking at averages of averages, models are the most effective tools for determining appropriate rates. While there is still some risk that model parameters have been chosen incorrectly, a reinsurer can adequately protect itself by adding on a risk load. As I have pointed out, there is a provision for such in this legislation.

Analysis of Legislation

RMS

Finally, let me describe the work done by Paragon to model this legislation. In this project we worked in conjunction with Risk Management Solutions, Inc. (RMS) of Menlo Park, California. RMS is a leading natural hazard modeling firm. It was founded

in 1988 by principals of the Stanford University earthquake engineering group, and is one of the world's authorities on the modeling of earthquake and hurricane risks. Their work is used by more than 300 insurers and reinsurers worldwide. The RMS model is also used by the Federal Emergency Management Agency to project likely losses from major disasters.

RMS produced industry loss events for this analysis. The RMS model used in this analysis contained 6682 simulated hurricanes[3] and 7519 earthquakes[4], which were created using statistical processes that started with the historical record of events from the U.S. Geological Survey and the National Weather Service. Their industry property database used in this analysis is based on data from the U.S. Census Bureau and the property databases of insurance companies throughout the United States. Loss events included insured residential losses only for the earthquake and hurricane perils.

Paragon

Paragon took the RMS loss events and developed a computer model to simulate a Federal reinsurance program based on the principles in H.R. 219. We focused our attention on the reinsurance portion of the bill. We would expect that because pricing on the auctioned reinsurance would be at least comparable to what would be received for the straight reinsurance of state programs, the results of the combined program would be similar to what we are presenting here.

Basically, what our model does is walk through simulated ten-year periods during which premiums to the reinsurance program are collected, losses are paid out as they occur in excess of each state's individual retention, and interest is earned on the fund

balance. Loss events for each year were simulated for hurricanes on the Atlantic and Gulf Coasts and in Hawaii, and earthquakes in California, the New Madrid fault zone, and in the state of Washington. We used each region's expected number of events per year[5] and the probabilities associated with the loss events to randomly sample the RMS loss data for annual catastrophe activity. The randomly selected losses were then reduced by each affected state's retentions to produce the Federal liability, subject to an annual $25 billion limit of the Federal reinsurance program.

We analyzed how the program would likely perform over this ten-year period under three different scenarios. In the first scenario, only the states that currently have programs--California, Florida and Hawaii--were assumed to participate. For the second scenario we included three additional states with high exposure to catastrophic loss and which have considered a state program: New York, Louisiana and Texas. In the final scenario, all states with significant hurricane or earthquake risks were assumed to buy Federal reinsurance. This included 25 states, either at risk from hurricanes or with major earthquake exposure on the West Coast or in the New Madrid fault zone.

As stated in the bill, we assumed reinsurance premiums would be set at twice the expected annual level, as determined from the RMS data. In the original legislation Federal reinsurance would begin after a $10 billion residential insured loss occurred in California or Florida, or a $2 billion residential insured loss in all other states. It is the results of this analysis that I am presenting today. We have also examined the effects of higher retentions in California and Florida, where state capacity may change from year to year, and the effects of raising retentions for other states to the size of a 1-in-100 year event. The results obtained in these subsequent analyses were comparable to those

presented here. Though there is language in H.R. 219 that gives the Secretary of the Treasury authority to phase-in the maximum yearly Federal liability, we modeled the program as if it incepted with $25 billion of coverage since no phase-in program had been defined.

Results of Simulations

Since the Federal program collected twice as much premium annually as it expected to pay in losses, it was clear that on average it would run a surplus. As is true in any insurance mechanism, however, one must examine the variability of expected outcomes in order to assess the true risk. To do so we simulated the 10-year cash flow of the Federal program 50,000 times for each of the three scenarios. To put it another way, each simulation analyzed the effects of hurricanes and earthquakes occurring over 500,000 years.

The results of the analysis were as follows. The average surplus in the program at the end of ten years was $5.7 billion if only California, Florida and Hawaii participated. If New York, Texas and Louisiana also joined, the ten-year average surplus rose to $7.0 billion. For all twenty-five states modeled the surplus was $13.3 billion. On average, the program sustained no claims in 95.7% of all years under the 3-state program and in 88.5% under the 25-state program. The likelihood of the program requiring a loan from the Federal government to cover a shortfall in any single year over the ten-year period ranged from 2.4% (with 3 states) to 3.1% (with 25 states).

I am pleased to be able to testify before the Banking Committee today on these issues in this forum, and I will be happy to answer any questions that you might have.

Thank you.

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[1] The difference between central pressure in the eye of the storm and ambient central pressure.
[2] The San Andreas is a strike-slip fault, while the Northridge earthquake occurred along a blind thrust fault.
[3] 5883 Atlantic and Gulf Coast and 799 Hawaiian hurricanes.
[4] 5751 earthquakes in California, 1294 in the state of Washington, and 474 in the New Madrid region.
[5] We simulated the number of events in a region using a Poisson distribution with the same mean as the expected number of annual events in that region, as determined by the RMS data.

WRITTEN STATEMENT

BY

JOEL FREEDMAN
SENIOR VICE PRESIDENT
THE HARTFORD FINANCIAL SERVICES GROUP

BEFORE

THE U.S. HOUSE COMMITTEE ON BANKING & FINANCIAL SERVICES

REGARDING

HR 219, "THE HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1997"

THURSDAY, APRIL 23, 1998

Mr. Chairman, Members of the Committee, my name is Joel Freedman, and I am a senior vice president at The Hartford. While The Hartford is a key member of the Reinsurance Association of America, which is also testifying today, and the American Insurance Association, both of which share in many of my views, my statement today and, particularly, my recommendations reflect only the position of The Hartford.

The Hartford is one of the nation's oldest and largest international insurance and financial services operations, with 1997 revenues of $13.3 billion. As of December 31, 1997, The Hartford had assets of $131.7 billion and shareholders equity of $6.1 billion. It is a leading provider of commercial property and casualty insurance, automobile and homeowners' coverage, and a variety of life insurance, annuities, employee benefits and asset management plans. In 1997, The Hartford wrote approximately $500 million in homeowners' premium. As of 1996, the last time insurers were ranked, The Hartford was listed as the seventh largest property insurer in the United States.

The Problem

In the wake of Hurricane Andrew in 1992, insurance experts have had to rethink what might happen if a major population center was struck by a natural disaster packing the destructive force of a nuclear weapon. With claims totaling more than $16.5 billion, Hurricane Andrew was four times more costly than Hurricane Hugo, the previous record disaster in 1989. Yet, it could have been much worse. Had the track of the storm veered 30 miles north through downtown Miami, insurers might easily have been looking at insured losses in excess of $50 billion.

Let us suppose for a second that an event of this magnitude does occur in the next several years. Wind speed at the time and point of impact will be 150 mph. Tornadoes in Florida will be spawned inland reaching velocities of 200 mph and will be as severe as the tragic ones we have seen this spring. Lives will be lost. Thousands upon thousands of houses will be destroyed. Automobiles and other personal property will be ruined. Schools and workplaces will be leveled or impaired -- interrupting education and employment for hundreds of thousands of Floridians. The economy of South Florida will simply be devastated.

Emergency workers and claims adjusters will speed to the region's rescue, but the magnitude of damage will be over three times that of

Andrew. Adjusters will move through the rubble and downed power lines to view the damage and issue checks. But the region will be slow to recover, with people displaced from their homes, schools and work.

Every industry -- from banking, utilities, and food services -- will feel the brunt of the storm, and every small and large business will suffer. But let me deal with the impact on only the insurance industry.

Insured claims of $50 billion will profoundly affect the property-casualty industry. This U.S. industry, covering personal and business risks throughout the world, has capital approximating $300 billion. Since state and federal law effectively precludes us from building catastrophic reserves, we will have to reach into our net worth. While this, in itself, may not sound earthshaking, the aftershocks will be serious. Some companies will disappear. Others will be significantly impaired, depressing their stock values and return to shareholders --both individual and institutional, such as pension plans. Most will be forced to sell assets quickly to cover claims, forcing the financial markets into a tailspin. On top of direct claim payments to their own customers, surviving companies and their customers will also have to pay assessments to the Florida Guaranty Fund to cover claims from customers of insolvent carriers. These same companies and policyholders will further have to shoulder assessments levied after the event by several of the state's insurance pools.

The impact of this tragedy will be felt in every state where businesses and individuals depend upon insurance, where state and local governments require debt financing and where insurance companies are located. Even states that may be immune to national disasters could likely experience availability and affordability issues. Connecticut, where one of every six jobs is dependent on insurance, will see its economy crippled. The financial aftershocks of a large-scale natural disaster are unlikely to remain confined to the insurance industry. Even if property insurers withstood the initial blow, there would be little capacity left over to write more business. Without available property insurance, mortgage lenders would be unlikely to write residential or commercial property loans. In a worst-case scenario, lending institutions might be left owning property diminished in value if owners were forced to abandon their property because insurers were unable to pay claims. "A substantial number of depository institutions could fail unless the banking regulators undertook a massive forbearance program," warned Jerry L. Thomas, a California bank chairman, who testified at a recent congressional hearing on behalf of the Western League of Savings Institutions.

This prediction is hardly the pulp of science fiction writers or mystics. Dozens of scientists, meteorologists and seismologists have predicted an

event of the magnitude just described or similar catastrophes in other states, such as California, Missouri, or New York. Remember, we can expect a hurricane with wind speeds the size of Andrew once every 7 years and an earthquake with intensity similar to Northridge every 10 years. My industry colleagues on the panel know it and most of the people in this room know it. What we don't know is where and when it will occur. The test will be if Congress acts before nature does.

A 1996 Insurance Services Office (ISO) study predicted that as many as half of the nation's property insurers would be rendered insolvent by a $100-billion hurricane or earthquake. What ISO's analysis tells us is that "in the event of the really big one, all current methods, including reinsurance, guaranty funds and pooling arrangements, may not provide enough capital" according to Michael Fusco, ISO vice president and chief operating officer.

Natural disasters present a particularly difficult problem for insurers because the normal spread of risk for property loss doesn't apply. Usually, fires and falling trees occur at random times over a wide geographic area. When a hurricane or earthquake strikes, a large amount of destruction occurs in a single time and place. Instead of one house going up in flames, an entire neighborhood may be leveled.

Compounding the problem is the fact that only certain areas are vulnerable to natural disasters. Hurricanes are mainly a threat along coastlines, while earthquakes happen along seismic faults. As a result, the only people likely to buy insurance against such perils are those who are in the immediate line of fire. Since there is virtually no spread of risk beyond disaster-prone areas, the cost of coverage is often quite high. "You can only spread the cost of catastrophe so much over the people of one state," Florida insurance commissioner Bill Nelson told this Committee's Housing and Community Opportunity Subcommittee at its 1997 Florida hearing.

The growing concentration of people and economic value in disaster-prone areas has combined with a upturn in the natural cycle of hurricane activity to produce a sharp rise in catastrophe losses. A 1996 report by Munich Reinsurance noted that in the previous 10 years there had been a four-fold increase in the number of catastrophes compared with the 1960s, an eight-fold increase in economic losses and a 15-fold increase in insured losses, even after adjusting for inflation.

A Conceptual Approach to a Solution

The Hartford believes that the solution to this problem must be comprehensive and multi-faceted. Property owners, insurers and reinsurers, capital markets, state and local governments, and the federal government all

have crucial roles. Of course, property owners have important responsibilities if they choose to live in a likely disaster area by sharing in the first layer of loss through higher deductibles and by making their properties as safe as possible. At this primary level, it is incumbent on property owners to take all reasonable steps to mitigate loss. Structural issues should be addressed whenever possible before construction and should be guided by appropriate and enforced building codes. Consideration should be given, where feasible, to retrofitting or strengthening existing structures to mitigate loss.

Once beyond this primary level, the private insurance and reinsurance sector should be the first line of protection for homeowners from catastrophic events. State programs that enhance private catastrophe insurance and reinsurance capacity are to be supported. Efforts that create new regulatory burdens on insurers or that create subsidies, hidden or otherwise, between lines of insurance or insurance companies, need to be opposed. The Hartford believes that the format of the Florida Hurricane Catastrophe Fund makes sense, but it begins coverage at too low a level and thus supplants available industry capacity to respond to a Florida event. A more ideal Florida fund would begin coverage at a higher level. As contrasted with Florida, The Hartford believes that the Hawaii Hurricane Relief Fund, which is a direct-writing facility (as contrasted with a reinsurance facility), does indeed supplant the private sector and thus does not elevate the total available capacity to respond to an event. Similarly, The Hartford believes that the California Earthquake Authority does not promote additional industry capacity, in that it provides coverage at a level where it is not needed and does not have the available funds to finance a truly catastrophic event.

Currently, there is a significant amount of capacity available in the private reinsurance market and capital markets to respond to catastrophes. Certainly price is a consideration in the purchase of these covers. However, one needs to take a long term view of availability and affordability when considering the need to respond to catastrophes. What is available or even affordable today may not be tomorrow. Hence, the need to consider an appropriately designed federal program.

The Hartford does not believe year-to-year profitability is illuminating on the issue of whether there is a problem or not. Nineteen ninety-seven was a relatively quiet year when it came to catastrophes. Over time, however, we know mega-catastrophes will occur. The question is whether as an industry and as a country we have the mechanisms in place to smooth the impact this event will have on the economy.

H.R. 219

While we can do little to deter the event itself, the loss of lives and much of the havoc, Congress and state legislatures can minimize property damage through improved building standards and enforcement and incentives for property owners. More importantly, this Committee and Congress can follow the lead of Congressmen McCollum and Lazio, as well as their late colleague, Bill Emerson, and Ted Stevens in the Senate, to provide a federal backstop for states and insurers seeking to write in those states. No state -- not even our largest -- has the financial and insurance capacity to meet the challenge of the storm or earthquake I have described. But working with the elements of H.R. 219 or the concepts of H.R. 230, states will be more readily positioned to weather the storm and insurers will be more willing to provide long-term protection in catastrophe-prone areas.

H.R. 219 provides necessary protection to back-stop existing state funds or qualifying ones that may be created. The version of H.R. 219 before you has several positive changes from its earlier draft. We believe that a state fund must meet certain minimum standards before it qualifies for reinsurance from the federal program. H.R. 219 now addresses this, while protecting existing funds, by establishing several appropriate minimum standards for any newly created state fund, including prevention of cross-subsidization between lines of coverage and allowance of a higher attachment point. Further, in its current form, H.R. 219 borrows from H.R. 230 in allowing for the parallel creation of a reinsurance auction process to provide needed coverage for private sector insurers and reinsurers across the United States. H.R. 219 reflects an appropriate balance between solvency concerns and minimal federal involvement in an existing private market.

Summary

Now, detractors will likely allege today that insurance catastrophe predictions are too alarmist. It is somewhat ironic that we rely on computers to fly us in airplanes, manage our financial world, and run our government but not to predict disasters.

Others will suggest that insurance and reinsurance are now plentiful and affordable in catastrophe-prone areas. If so, we would not be here today and insurance regulators would not be seeking to roll back rates in states, such as Florida.

Lastly, still others will claim that these two proposals and their predecessors in prior Congresses are no more than federal bail-outs for California, Florida, Hawaii, and property insurers. The beauty of these

proposals is that they unfold a federal umbrella at no cost to the Treasury over the long term, while shielding the economy from the events I previously outlined.

The Hartford's twin objectives have been flexibility and action. We have been willing to work with anyone in Congress or the industry on developing a constructive proposal. We applaud this Committee's action in giving serious consideration to this issue. The disasters I have described will occur. The question is where and when. The time to act is not a question -- it is now.

Nearly 30 tropical cyclones pounded the eastern Pacific in 1992 and fortunately only one struck the Hawaiian Islands. With winds of 125 mph, Hurricane Iniki battered Kauai and left behind $1.5 billion in destruction. If the same storm had hit Honolulu, it is estimated that the damage would have been closer to $20 billion in insured losses.

Early in 1994, the Northridge Earthquake shook the ground 20 miles from the city of Los Angeles for just a few minutes, but the pictures we all saw of what it did to the lives and property of thousands of Californians will last us a lifetime. Damage covered 2,192 square miles and insurers lost $13 billion.

These events not only forced the insurance industry to examine their catastrophe exposure more closely, but also forced these states to examine their capacity to survive natural disasters as well. State officials found themselves with economies struggling to rebuild and insurance carriers looking to minimize further risk. In an effort to address these concerns and a growing insurance availability crisis, industry and public leaders came together and examined what could be done for their individual states.

The results to date have been the formation of the Florida Hurricane Catastrophe Fund, the Hawaii Hurricane Relief Fund and the California Earthquake Authority. Allstate was involved in the extensive discussions surrounding the development of these organizations which have helped to ease the crisis in the Florida, Hawaii and California property insurance markets. The formation of these entities represents true public/private partnerships where both business and consumers benefit.

Although the efforts in Florida, California and Hawaii are noteworthy and meaningful, they also have their limitations. These state entities have sufficient capacity to cover the majority of catastrophes, but could not cover losses from worst-case disasters. Current state programs and those which other states might develop need the support of a federal backstop, such as that envisioned in H.R. 219.

Allstate believes that H.R. 219 will make state natural disaster plans much more stable, thereby increasing the likelihood of sustaining a viable insurance market after a substantial catastrophe. Not surprisingly, however, in a subject of this magnitude and bill of this nature, there are always differing insights and opinions. I'd like to examine for the Committee some of the myths and misconceptions that you may hear about H.R. 219 during today's hearing:

- **H.R. 219 is an insurance industry bailout.**

  This legislation is not a federal government bailout for either insurers or policyholders. A bailout occurs when people sit around knowing there is a problem and do nothing about it. When the problem then arises, they hold out their hand for a government check. That is the system we have operating today to deal with natural disasters. We need to change that system and H.R. 219 will go a long way toward making that change.

STATEMENT OF

ROBERT W. PIKE
SENIOR VICE PRESIDENT, SECRETARY & GENERAL COUNSEL
ALLSTATE INSURANCE COMPANY

on

H.R. 219,
HOMEOWNERS' INSURANCE
AVAILABILITY ACT OF 1997

before the

Committee on Banking and Financial Services
U.S. House of Representatives

April 23, 1998

Mr. Chairman and members of the Committee, thank you for the opportunity to present testimony in support of H.R. 219, the Homeowners' Insurance Availability Act of 1997. We commend Congressmen Lazio, McCollum and Fazio for the leadership they have shown in introducing this important legislation and Chairman Leach for scheduling today's hearing.

Allstate is the largest publicly-traded property and casualty insurer in the country and has a vital interest in natural disaster legislation. We and other property and casualty insurers have worked for nearly twenty years to address the problem of property insurance availability caused by major natural disasters. Our efforts have led us to a number of state legislatures and to Congress as well. As you may know, three states -- Florida, California and Hawaii -- have developed programs and other states are considering various alternatives. But despite these important steps, state programs need to be supplemented by actuarially-sound federal reinsurance to cover the largest and most costly natural disasters.

H.R. 219 would authorize the establishment of a limited federal reinsurance backstop to state disaster insurance programs. This would result in significant benefits not only to homeowners who live in disaster-prone regions, but also to all taxpayers since federal disaster relief expenditures will certainly rise if private homeowner markets continue to deteriorate.

It is said that Hurricane Andrew lasted only a few minutes and yet felt like an eternity. Those few minutes of 134 mph winds devastated the lives of thousands of people. In those few minutes, all of the profit that Allstate had earned in all lines of insurance during 50 years of operations in Florida were erased. Insurers incurred more than $16 billion in losses. If Andrew had hit just 50 miles north in Miami, the cost of that hurricane, it is estimated, would have exceeded $50 billion in insured losses.

This legislation will provide states with an opportunity to purchase federal reinsurance at a cost of twice the actuarially projected risk. It addresses events which will occur, on average, only once per 100 years. This means that 99 percent of disaster risks will be retained by insurers and the states directly. Any revenue shortfall in the program -- a remote possibility-- must be repaid by the program's participants from future premiums. I think it is important for the Committee to recognize the relatively low level of risk that the federal government would assume under this legislation and that all obligations will be repaid.

- **There is plenty of money in the reinsurance and capital markets to take care of the problem.**

Following Hurricane Andrew, the reinsurance marketplace contracted, at the same time that insurance companies were requesting more coverage for their customers in Florida and other areas. It took more than a year for capacity to return to prior levels, and to begin to meet the increased demand for coverage. The continuing unavailability of voluntary property insurance in a number of locations, such as southern Florida, parts of Louisiana and Texas, demonstrates that reinsurance and capital markets capacity still has not met the full demand for coverage in Florida and these other areas, at prices that make economic sense for primary insurers.

Reinsurers may suggest that $25 billion of reinsurance capacity exists in the U.S. But it should be noted that, while $25 billion may be available as a U.S. aggregate, the figure is closer to $5 to $10 billion for any given region of the country. When you consider that this amount must be allocated among commercial and residential lines of insurance, the actual amount available to cover homeowners insurance losses is small, relative to the potential loss. The $10 billion coverage available in any region represents only one-fifth to one-thirteenth of the $50 to $130 billion events that are possible.

Some will argue that reinsurance capacity is still developing in the traditional reinsurance markets and in capital markets. But how long must primary insurers and the consumers in many states wait for their needs to be met? While we have seen some improvement in reinsurance capacity since 1994, the market has fallen short of the increase in demand. For example, we do not see the substantial additional capital that has been added since 1995 to Bermuda catastrophe reinsurance companies being applied to significantly increase catastrophe reinsurance capacity in the U.S.

There also were extreme changes to reinsurance pricing following Hurricane Andrew. Reinsurance prices increased from 200% to 500% from 1990 to 1995. Prices have since moderated but still remain 80% to 300% over 1990 price levels.

Consider what these dramatic movements in price and availability of reinsurance did to the primary insurance market. Many companies, including Allstate, were forced to

withdraw or drastically curtail their participation in some markets, because they could not obtain adequate reinsurance coverage at economically viable prices.

Allstate is one of the largest purchasers of catastrophe reinsurance today. We have $475 million of coverage for hurricanes impacting states in the Northeast. We would have considered purchasing more coverage, but at the time we requested the coverage from the reinsurance market, $475 million was all that was available.

Allstate has $1.1 billion of reinsurance coverage in Florida, $700 million of which is provided by the Florida Hurricane Catastrophe Fund. The remaining $400 million was purchased from a reinsurer. Allstate could not possibly place all $1.1 billion in the private reinsurance market; that level of coverage simply does not exist for a single insurer, at prices that make economic sense for primary insurers. That is why the CAT fund was created. Should a significant portion of the CAT Fund coverage become unavailable, we and many other insurers would have to reconsider our participation in Florida's homeowners insurance market.

We believe that a stable market for homeowners insurance is in the "Public Interest," and is really at the heart of this issue. A homeowners market that is sustainable and stable, even after a large catastrophe, requires

- adequate reinsurance coverage,
- reasonable stability in reinsurance capacity and prices and
- the ability to reflect the costs of reinsurance in homeowners insurance premiums.

- **H. R. 219 will lead to federal regulation insurance.**

Allstate would not support legislation that diminished the role of state regulation or created dual regulation -- both federal and state. H.R. 219 is not a nose under the camel's tent for federal regulation of the industry. In fact, it is a tool for state insurance departments to use in order to avoid a meltdown in the markets that state insurance commissioners have been sworn to protect.

Legislation that the insurance industry and others helped to craft in previous Congresses would have resulted in far more federal intrusion. H.R. 219, in our view, preserves state regulation of insurance and calls for a very limited amount of federal decision-making and oversight. In addition, it appropriately limits the federal government's liability. Rather than establishing unwarranted and undesired federal regulation, H.R. 219 is a measured and balanced response to this critical national problem.

- **The bill will encourage state programs where they are not needed.**

There is no evidence that state programs have been created except in cases of extreme crisis. Only states that have experienced significant natural disasters -- California, Florida and Hawaii -- have chosen to intervene. The fact is that state programs will only be created where there is a critical need because state programs cost money and no state will venture into this arena unless they have no alternative.

- **H.R. 219 will crowd out opportunities for private markets.**

There is absolutely no evidence that state programs crowd out the private sector. In fact, there is ample information indicating that exactly the opposite is true. The California Earthquake Authority buys $2.5 billion of reinsurance from private capital sources -- more than any other entity in the world. The Florida Catastrophe Fund utilizes lines of credit arranged by Chase Manhattan Bank, among others. Even the Hawaii Hurricane Relief Fund is a major buyer of private reinsurance. Although reinsurance is too expensive for more than a fraction of their exposure, every state program is working in partnership with the private sector. Furthermore, there is a shortage of private reinsurance in Florida today, even with an $11 billion Florida Catastrophe Fund.

- **H.R. 219 will encourage more people to live in harm's way.**

It would be nice to believe that all Americans could move to Wyoming to be out of harm's way. The facts are that, according to the Commerce Department's own statistics, 75% of the U.S. population will be living within 100 miles of a U.S. coastline by the year 2010. It is unrealistic to suggest that the availability of homeowner insurance, or the lack thereof, will have a sizable influence on where people live. We cannot depopulate Los Angeles, Houston, New Orleans, Long Island, Raleigh, Richmond, San Francisco, St. Louis, Memphis, Seattle, Ft. Lauderdale, Boston, Baltimore, Portland and Charleston.

The insurance industry has a $310 billion surplus and earned record profits last year. Companies won't write in risk-prone areas because they are seeking to maximize profits.

Some today may try to tell you that the insurance industry is awash in capital and made record profits last year. The story is not so simple. First, the $310 billion figure applies to all types of insurance, not just homeowners insurance. In fact, only about 10% of insurance industry premiums cover homeowners insurance losses. The truth is that the surplus which backs homeowners insurance exposures is more like $30 to $40 billion, not $310 billion. And this figure applies to homeowners insurance sold throughout the United States. The amount of surplus backing insurers that write in certain parts of the country is a small fraction of the total.

But let's examine the issue even further. The combined ratio for insurance refers to the relationship between the amount of premium collected from customers and the amount paid for claims and expenses before investment income. In 1997, the combined ratio on an industry-wide basis for homeowners insurance was 105.4. That was our best number in five years. In 1997, for every dollar we collected in premiums, we paid out $1.05 in claims and expenses. In 1996, we paid out $1.22 compared to $1 in premiums. In 1995, the figure was again $1.22. In 1994, the figure was $1.18 in losses and expenses for every dollar in revenue. And in 1993, the figure was $1.14. The fact is that homeowners insurance has been an extremely difficult way to make money. And that has been particularly true in high risk areas.

- **This legislation will help only residents in Florida and California.**

  On the contrary, H.R. 219 should be viewed as providing availability of federal catastrophic reinsurance to all areas of the country. While our most recent memories are of Hurricane Andrew in 1992 and the Northridge Earthquake in 1994, the total insured losses for which were nearly $30 billion dollars, natural disasters can occur -- and have occurred -- in many other locales. Texas has suffered severe hurricanes, much of the East Coast is in the path of potentially serious storms, the Northwest -- Alaska, Washington and Oregon -- could experience devastating earthquakes. And then there's the New Madrid earthquake fault in the heartland of America which during its last incarnation in the early 1800's rang church bells in Boston, caused scaffolding in the U.S. Capitol Building to collapse and even changed the course of the Mississippi River.

  Several states recently have considered taking steps to address this problem, including Missouri, New York, Arkansas and Louisiana. What we need -- and H.R. 219 will provide -- is a solution that assists existing state programs, as well as other states that express a desire for and are willing to purchase federal government reinsurance.

In conclusion, Mr. Chairman and members of the Committee, let me reiterate Allstate's support for the pending legislation, H.R. 219. We think it is an appropriate federal response to the problem of natural disasters. Further modifications in the bill's language may be necessary to satisfy some concerns you may hear expressed today, and we would welcome an opportunity to provide you with our input on these matters. Thank you again for the opportunity to present this testimony.

**STATEMENT OF
MR. RADE T. MUSULIN
VICE PRESIDENT AND ACTUARY
FLORIDA FARM BUREAU CASUALTY INSURANCE COMPANY
FLORIDA FARM BUREAU GENERAL INSURANCE COMPANY
BEFORE THE
BANKING AND FINANCIAL SERVICES COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.
April 23, 1998
ON
H.R. 219
THE HOMEOWNERS' INSURANCE AVAILABILITY ACT**

My name is Rade Musulin. I am Vice President and Actuary of the Florida Farm Bureau Insurance Companies and a member of the Casualty Actuarial Society and the American Academy of Actuaries. My company is part of the Southern Farm Bureau Group, which insures property risks in six southeastern states for members of the Farm Bureau Federation. Our group is exposed to both hurricanes in the Gulf and Atlantic coasts as well as earthquakes in the New Madrid and Savannah River areas.

I serve on the Advisory Council of the Florida Hurricane Catastrophe Fund and participated as a member of an ad-hoc working group directed by Senator Ted Stevens' staff in 1996 on disaster insurance.

I appear before you today on behalf of the Florida Farm Bureau Casualty and the Southern Farm Bureau Casualty Insurance Companies. We are members of the National Association of Independent Insurers, a non-profit property/casualty trade association representing more than 560 insurance companies on whose behalf I also am testifying.

Throughout the country, Farm Bureau Insurance Companies provide many Americans with property insurance coverage through single state or regional companies. Companies like ours are critical parts of the insurance marketplace. Federal Initiatives in property insurance should place state and regional companies on an equal footing with large national ones.

I am here to express our support for efforts, particularly those of Representatives Lazio and McCollum, to draft legislation to better prepare for extremely large and devastating natural disasters.

For the Southern Farm Bureau Group, capital, reinsurance and financial markets are providing the capacity needed to manage most catastrophes. However, exposure to a mega catastrophe in highly populated or concentrated areas cause significant concern to our group of companies and to the industry.

The Federal Government can play a very constructive role, in partnership with the states and the insurance industry, in assuring that the insurance system has sufficient resources to honor obligations to consumers in their time of need and, equally importantly, has the ability to function after the disaster with a minimum of disruption to consumers, the industry and the financial markets.

We believe that:

- Federal programs should compliment, rather than replace, private sector capacity.

- No program should create a market advantage for certain segments of the insurance industry, or for government sponsored pools, over the private sector.

- Federal efforts should facilitate the emergence of new capital market products that have the potential to diversify risk throughout the world financial system.

- Federal efforts should not interfere with the traditional role of states as the primary regulators of insurance.

H.R. 219 as reported by the Subcommittee on Housing and Community Outreach is a well-intended step in the right direction. We want to continue to support the bill as it moves forward. However, we believe H.R. 219 can be strengthened in order to:

- increase the likelihood that policyholders in disaster prone areas will have insurance claims fully paid in the event of large catastrophic events;

- increase insurance industry capacity so that the number of homeowners able to adequately insure their homes and possessions is maximized:

- assure that insurers of all sizes and in every marketing area will be in a financial position to pay catastrophic disaster claims and be able to respond to future catastrophic events.

We were pleased to see that the Subcommittee, in reporting H.R. 219, included provisions for excess-of-loss catastrophic reinsurance contracts.

Having participated in the creation and implementation of the Florida Hurricane Catastrophe Fund, I can attest to the challenges that may face other states if they elect to create state funds. While Florida's Catastrophe Fund is an excellent example of a state program that has complimented the private sector and provided considerable claims paying capacity to the system in a financially sound manner, what has worked in states with the most severe problems may not be best for the rest of the country. Many states may not have the financial base or expertise to support such a mechanism.

For this reason, we agree with the Subcommittee that Federal Excess of Loss Contracts would afford property insurers a valuable secondary source to the private sector for high level disaster insurance protection. Contracts should be made available to insurers and state programs directly by the Federal Government. This would allow the government to enhance claims paying capacity in many states without the need for additional state government programs, while not interfering with states' ability to maintain existing programs or to create new ones.

We strongly agree with the Subcommittee that the state level is the most appropriate geographic focus for the sale of reinsurance contracts and disagree with those who have argued that such contracts should only be made available on a national basis. Contracts must be structured in a way to be useful to regional and single-state insurers.

While several insurers market their property insurance coverege on a national basis in most or all states, the substantial majority of property insurance companies operate in only one or a handful of states. National contracts help only one segment of the large and diverse insurance industry. The advantage of single-state contracts is that insurers only would need to purchase contracts for the state or states in which they have a catastrophic exposure.

We urge the Banking Committee to adopt the concept contained in H.R. 219 for auctions of Treasury Excess of Loss Reinsurance Contracts on a state-by-state basis so that single state or regional insurance companies can participate without having to bid on what are likely to be more expensive national contracts. Contracts could be allocated to states by the Treasury Department based in the probability of a catastrophic event occurring in the state and the premium volume of insuring entities doing business in the state. Regional and single state insurance companies bear significant risk in many disaster prone states and often fill gaps in coverage not written by large national writers. They should be able to fairly participate in the program.

The Subcommittee made a sincere effort to address this concern by including in Sec. 4 of H.R. 219 a provision for "State Auction Programs." However, we think this provision may be unworkable. At this time, no state has enacted, nor has any state proposed legislation to provide for a state auction program. Some states have a severe exposure to one or more catastrophic natural disaster peril, even though a catastrophic event has not occurred for a century or more. It could be difficult for legislatures in some of these states to appreciate the magnitude of the exposure to their residents. State auction programs likely would vary in context, application and consistency. Furthermore, H.R. 219's current requirement for the states to create and administer "state auction programs" adds an unnecessary and expensive requirement that states act as intermediaries between the U.S. Treasury and private insurers.

We strongly urge that H.R. 219 be amended to simply allow insurers and reinsurers to purchase Excess of Loss Reinsurance Contracts direct from the U.S. Treasury Department. We believe that this change will bring broader industry support for H.R. 219.

There has been a great deal of debate over the amount of retained losses for insurers, or, as it is commonly stated, the trigger for U.S. Treasury Excess of Loss Reinsurance Contracts. We believe that Treasury contracts should be triggered by substantial losses which would threaten the solvency of the insurance industry and its ability to continue to serve policyholders. Triggers for individual states should vary according to the probability of catastrophic events and the size of the state insurance market. Interestingly enough, H.R. 219 does this for the Hawaii Fund. Triggers should be established as a part of the Treasury Department contracts with the advice of the Loss Cost Commission created by H.R. 219.

We believe that a system of state auctions of U.S. Treasury Excess of Loss Contracts can be developed which will not compete with the private capital market and could be structured to actually complement the private market by providing a needed high layer of catastrophe reinsurance above the private market. The Secretary of the Treasury should be charged with the duty of taking into consideration developments in the capital marketplace when he establishes an Excess of Loss Reinsurance program under this legislation.

The Loss Cost Commission is an important part of this legislation and will ensure that expertise will be available to the Treasury to price the product to reflect exposure.

Consumers in many states are facing property insurance availability problems, which could explode after the next catastrophic event if the insurance system's financial solidity is damaged. This issue is critically important, and should be a high priority for Congress and the Administration

We appreciate this opportunity to convey our support for the concepts contained in H.R. 219 and to make our recommendations for improving and strengthening the bill.

Thank you.

Statement of Roger Joslin

Chairman of the Board

State Farm Fire and Casualty Company

On

The Homeowners' Insurance Availability Act of 1997, H.R. 219

Before the House Banking and Financial Services Committee

April 23, 1998

INTRODUCTION AND SUMMARY

My name is Roger Joslin. I am Chairman of the Board, State Farm Fire and Casualty Company, the largest writer of homeowners insurance in the United States.

State Farm strongly supports a federal role in providing a financial backstop in the event of very large natural catastrophes. H.R. 219, the Homeowners' Insurance Availability Act of 1997, represents a very sound approach for which we complement Subcommittee Chairman Lazio and members of the subcommittee from both sides of the aisle. H.R. 219 can be improved and there are other approaches we can support as well, but we need to avoid having the search for perfection prevent passage of the good.

There are several principles which should be followed in developing legislation in this area. First, the resources of the federal government should be called upon only rarely; for example, only for events approaching the magnitude of Hurricane Andrew and the Northridge California earthquake, or events likely to occur less frequently than once per 100 or more years. Second, the price of federal backstop mechanisms should properly reflect expected losses--no subsidies for catastrophe prone areas--while recognizing the superior capacity of the federal government to absorb the timing risk of mega catastrophes; and third, the backstop mechanism should have continuity so as not to evaporate during or following a major event. Fear of a second event may be even more disruptive of market mechanisms than concern about the consequence of a first event. H.R. 219 meets the first two principles head on. It can be strengthened as to the third principle.

A 100, 500, 1,000, 10,000 year event by definition occurs very rarely. Yet such an event could happen tomorrow. All those with a stake in this issue -- the insurance buying public, the states, the private sector and the federal government -- must play a role in crafting a solution. Now, when the country is free from the trauma associated with a major catastrophic event, is the time for Congress to enact legislation creating a meaningful Federal-state-private partnership to lessen the impact of disasters.

THE PROBLEM

According to well accepted estimates, insured losses from major natural catastrophes in several regions of the country such as California, the Southeast including but not limited to Florida, and the Midwestern earthquake zone, could reach as high as $75 billion to $100 billion. Events of this magnitude far exceed the claims paying capacity of most private insurers and all existing state funds. Other regions facing potentially devastating catastrophic losses include the upper Atlantic Coast, ranging from New Jersey north, and the Gulf states, ranging from Texas east. Smaller markets with very high potential losses relative to their size include Hawaii and Alaska.

While we can point to the New Madrid earthquake of the early 1800s, the 1906 San Francisco earthquake, the 1938 Long Island hurricane, Andrew and Iniki in 1992, and Northridge in 1994, as examples of major catastrophes, none of these represent the worst that can happen. Further, the relatively small number in our consciousness brings home the fact that the largest of natural catastrophes are very infrequent occurrences.

Yet after Iniki, Andrew and Northridge, the homeowners insurance markets in Hawaii and major parts of Florida and California became dysfunctional. State-sponsored mechanisms to assume and pool the most severe risks were the responses necessary to reopen insurance, and thus real estate, markets.

These necessary, but limited, mechanisms would barely be able to respond to events the size of Andrew and Northridge, let alone the very possible much larger catastrophes. They would for many years have absolutely no ability to cope with a second event. The California Earthquake Authority currently has the capacity to pay up to approximately $7.25 billion in earthquake losses. The Florida Hurricane Catastrophe Fund currently provides approximately $11 billion of reinsurance coverage to primary insurers. Most of this is supported by authority to impose post event assessments to repay loans, not genuine prepaid risk transfer. The Hawaii Hurricane Relief Fund would not be able to pay all the claims from another Iniki (which hit the small island of Kauai) let alone a severe storm hitting Honolulu on Oahu.

Capacity/Price

Theoretically, there is more than enough capacity (capital) in private markets to insure/reinsure the worst of natural disasters. Reality, for a number of reasons, is otherwise.

Primary insurers in the aggregate have substantial capital, but relatively little of it is devoted to homeowners insurance in mega catastrophe prone areas. Many companies do not insure homes. Many which do, do not write in the "break the bank" areas. One factor discouraging companies from writing in these areas is politically motivated rate suppression. Those who do write homeowners insurance in these areas restrict their exposure due to limited capital or concern about earnings volatility.

The entire capital base of reinsurers is not large and they must balance their portfolios. Only a fraction of their capital is available to assume risks in any single area.

The capital markets--pension funds and other institutional investors--have large financial resources, but very little of it has reached the catastrophe insurance market. And the price has been high--8.2 times the estimated annual average loss cost in the one significant transaction to date. After a major event, the price of such securities, if available at all, most likely would be higher.

In response to a specific question posed by the committee, one or two years of profitability, or three years without an event of the magnitude of the Northridge earthquake, changes nothing in regard to the need for federal financial backup for events having an occurrence likelihood of less than once in 100 years. I am reminded of commentary in Florida to the effect that, except for a single isolated event, the insurance business in Florida has been profitable. That single isolated event consumed more capital in half an hour than State Farm Fire and Casualty had accumulated countrywide in its 60 years of existence.

Risk of Ruin

Actuaries have formulas placing prices on exposing pools of capital to the risk of ruin (bankruptcy). As one could expect, the owners of capital expect a higher return when there is a risk of total loss.

Too often financing of a natural catastrophic loss is described as accumulating the funds necessary to pay the loss over a period of years. Unfortunately, a 100 year event can occur in the first year. Even more frightening, so can a 10,000 year event. No private enterprise can earn a competitive rate of return in the business of insurance sitting on this quantity of stagnant capital.

United States tax policy further aggravates the problem. In most years, insurance of high magnitude, low incidence events generates tax liabilities on profits that really do not exist. Yet in 1997 the loss carry- back period was reduced from three to two years. Even if the proverbial 100 year event were to occur at the statistical mid-point of 50 years, 49 years of profits would have been taxed with only two of those years being available for recovery.

THE SOLUTION

H.R. 219, the Homeowner's Insurance Availability Act of 1997, is a major improvement over the status quo. It's most important features are: (1) federal reinsurance for the state funds set up to insure or reinsure catastrophic risk; and (2) a price based on estimated average annual losses plus a reasonable margin for the contingency of loss estimation error.

In regard to the federal financial backup of private insurers, State Farm does not support the Federal government providing individually negotiated reinsurance on a company specific basis. H.R. 219 avoids this quagmire. State Farm does support the concept of an auction of excess of loss contracts to private insurers, reinsurers and even the capital markets on a state, regional or national basis. Because market imperfections and failures have largely been in the area of residential insurance, if choices must be made, backup priority should be for residential insurance. However, the very largest estimates of potential catastrophic losses clearly include insured commercial property losses. Even though State Farm has a relatively small non-residential property insurance portfolio, we urge consideration of extension of the excess of loss contract concept to include non-residential property insurance coverages.

The aspect of H.R. 219 which needs strengthening is the commitment to fully fund the large losses which fall within the scope of the federal backup promise. This includes multiple

mega events in the same year. The mere possibility of unfunded catastrophic losses sends tremors through the insurance and lending communities. Along these lines, the Committee should consider transforming the bill's $25 billion limit on the federal backstop from a per year to a per event limitation.

In conclusion, I want to thank the Chairman for holding this important hearing and giving me the opportunity to appear before the Committee. There is an urgent need for federal legislation to address the natural catastrophe issue. Major weather and seismic events are increasingly likely and the number of citizens exposed to these hazards is escalating. The federal government has a critical role to play in this process in partnership with the insurance buying public, the states, and the private sector. It should enact meaningful legislation, such as the Housing Subcommittee reported version of H.R. 219, to create a meaningful federal-state-private partnership to lessen the impact of these disasters.

I would be happy to respond to questions from members of the Committee.

48-232 98 - 11

CBOT

Testimony of Sylvie Bouriaux
Group Manager, Financial Products
Chicago Board of Trade
before the House Banking Committee

April 23, 1998

Thank you for providing the Chicago Board of Trade (CBOT) with the opportunity to discuss the latest developments in catastrophic reinsurance alternative products, most notably the PCS Catastrophe Insurance Options contracts currently traded at the CBOT, and to demonstrate that private markets have recognized the threat of large disasters and are acting to develop a variety of solutions to that problem. As the world's oldest and largest futures and options exchange, the CBOT has 150 years of experience in providing risk management tools to an evolving group of markets and industries, from cash grain markets to the interest rate futures in the 1970s, and today to the insurance community.

In 1848, the CBOT was founded to provide a rational, effective and inexpensive mechanism for buying and selling physical agricultural commodities. Our simple, but effective cash grain markets started our evolution into the world's busiest futures exchange. Our marketplace serves the worlds of agriculture and finance by providing instruments for managing different types of risk. We currently sponsor trading in over sixty different futures and options markets. These markets provide an efficient, reliable mechanism for transferring risk and generating price information that is disseminated around the world to provide a benchmark for market decisions. Today, the CBOT provides a centralized market for buying and selling catastrophic reinsurance, which generates similar benefits for those involved in this innovative market. The free-market risk transfer solution offered by the CBOT has proven very effective in other new areas as well, such as the environment. The CBOT has already presided over three annual auctions of sulfur dioxide emission allowances on behalf of the Environmental Protection Agency, and plans to provide a centralized market for trading sulfur dioxide emission allowances. The market-driven approach to this environmental problem has enabled affected parties to significantly reduce and manage the cost associated with cutting emissions.

In this testimony, I intend to provide a broad overview of the latest developments in insurance derivative products traded on various exchanges worldwide, but with a primarily focus on the Chicago Board of Trade's experience in this area.

Background

In the aftermath of Hurricane Andrew in 1992 and the Loma Prieta earthquake in 1994, the insurance industry began to seek and encourage new sources of funding, recognizing that increased reinsurance capacity beyond the traditional reinsurance market was needed to cover what was clearly a much larger potential risk exposure. At the same time insurers were seeking new methods for managing risks, third parties such as capital markets (including the Chicago Board of Trade) recognized the industry disequilibrium that existed and introduced new products, such as CAT options, swaps or bonds, to expand reinsurance capacity and improve market efficiency. In fact, in the spring of 1992, prior to the occurrence of Hurricane Andrew, the Chicago Board of Trade had already begun to develop capital market solutions designed to allow insurance companies and reinsurance companies to transfer their catastrophe risk to the broader investment community more efficiently.

The first catastrophe index futures and options contracts began trading at the CBOT on December 11, 1992. A second version of the contracts, based on different, aggregated insured catastrophe loss estimates compiled by the Property Claims Services ("PCS"), began trading at the Exchange in September 1995. Today, the CBOT's product mix includes PCS Catastrophe Insurance options for nine regions and states: National, East, Southeast, Northeast, Midwest, West, Florida, Texas and California. These are cash-settled options based on an index of insured losses derived from PCS data. Insurers and reinsurers buy these options as synthetic reinsurance covers in order to complement their traditional reinsurance or retrocession program. PCS options can be traded based on catastrophe triggers (or "option strikes" in futures parlance) to protect and

compensate the insurance industry against catastrophes that would trigger up to $50 billion of insured losses in each of the nine regions and states listed at the Exchange.

In the past two years, other exchange-based initiatives have followed the CBOT footsteps. First, in 1996, the New York Insurance Department approved the Catastrophe Risk Exchange ("CATEX") as a reinsurance intermediary. Then, the Bermuda Commodity Exchange opened its doors on November 12, 1997 to trade insurance options conceptually similar to that already traded at the CBOT.

CATEX can be broadly defined as an electronic bulletin board on which insurance companies (CATEX subscribers) can list risks that they are eager to cede (under a traditional insurance treaty format) or to swap against other risks (reinsurance swap transaction). For instance, under a reinsurance swap transaction, an insurance company may decide to "swap"10 units of New Jersey windstorm risk against 15 units of Ohio Valley tornado risk (a standard unit of risk is worth $1 million).

CATEX has not been technically designated as an Exchange, but as a reinsurance intermediary by the New York Department of Insurance. Under New York law, CATEX can not allow capital market firms, such as banks, dealers, hedge funds or "transformer" firms to access the system. However, this is bound to change soon as CATEX, in a joint venture with the Bermuda Stock Exchange, plans to start operations in Bermuda. This will allow CATEX to expand on the product side to include standardized reinsurance program offerings and to include capital market players.

The Bermuda Commodities Exchange ("BCOE") was created as the result of an original venture between the American Insurance Group ("AIG"), Guy Carpenter & Company, Chase

Manhattan International Finance (an affiliate of Chase Manhattan bank), and other smaller entities. To date, membership on the exchange has increased to 30 firms. The BCOE is structured as a for-profit organization with its members also being shareholders in the venture. The instruments offered on the BCOE are conceptually similar to the CBOT products. They are cash options based on an underlying index or on a single loss event and are expected to trade similarly.

Volume in CATEX and BCOE products to date has been negligible. However, open interest in the longer-established CBOT's PCS Catastrophe Insurance Options has continued to grow. Let me describe the CBOT products in more detail.

CBOT's PCS Catastrophe Insurance Options

Generally, exchange-traded CAT instruments differ from reinsurance in that they are more standardized, not negotiated as with traditional reinsurance. To facilitate trading, they are standardized in terms of the regions and states covered and in the period during which the losses must occur. The buyer and the seller of these contracts do not negotiate the specific terms of these contracts, only their value, which is determined on the trading floor using the traditional open outcry method which has been an effective price discovery mechanism for 150 years.

Price information for any CAT contract bought and sold on the CBOT is then disseminated throughout the world, providing a base from which decisions to buy or sell protection against potential catastrophic losses can be made. This price transparency feature is a key attraction to capital from outside the traditional insurance industry. New private investors, interested in assuming a segment of the risks that were previously available only to reinsurers, can now become sellers of standardized reinsurance at the CBOT.

The CAT contracts are based on a recognized index of insured industry catastrophe loss estimates for catastrophic events that occurred during a specified time period, usually a quarter or a year for a region, a state or nationwide. The CAT contracts are quoted in points. Each point represents an industry loss of $100 million. As an illustration, an index value of 100 translates into aggregate industry catastrophic losses of $10 billion. Currently, the CBOT CAT contracts are capped at a maximum level of 500 or about $50 billion for each region and state.

One of the most popular CAT instruments traded at the Chicago Board of Trade for catastrophic risk mitigation purposes is called a call option spread. In essence, call option spreads are very similar to aggregate excess of loss contracts. Catastrophe insurance call spreads allow an insurance company or a reinsurance company to buy a "layer" of protection between two attachment points, called "strike prices" in our financial jargon. A buyer of a call spread would buy an option at one attachment point and simultaneously sell an option at a higher attachment point. The buyer can select the desired attachment points. For instance, let's analyze a transaction that occurred on our markets on April 8, 1998 -- a 1998 Western Annual 150/200 call spread at a premium of 2.5 points. An insurer or reinsurer who wants to protect, or supplement the protection of, his earthquake exposure in the West bought that layer at the Chicago Board of Trade. A 150/200 Western call spread translates into industry catastrophic losses between $15 and $20 billion. In our markets, each point is worth $200. The insurer or reinsurer paid a premium of $500 (2.5 points times $200) per option in order to receive a cover of $10,000 per option (50 points of protection times $200) and the seller (a reinsurer or an investor) received that premium for assuming that risk. As 100 options exchanged hands in this transaction, the total cover bought was $1 million and the total premium paid was $50,000 or the equivalent of a 5% rate-on-line, to use insurance industry jargon.

If aggregate losses in the Western region during 1998 are below the attachment point of 150, or an equivalent industry loss of $15 billion when the option expires, the call spread has no value and the insurance company will not be indemnified. If aggregates losses are above 200 or an equivalent industry total loss of $20 billion, the insurance company will receive the maximum possible indemnity of $1 million minus the premium paid up-front. The company will also be compensated against losses at any point between the 150/200 triggers. For instance, if losses amount to 175 or an equivalent industry loss of $17.5 billion, the insurance company will receive a compensation equal to the dollar difference between 175 and 150, minus the premium paid up-front.

No doubt exists about the ability to collect that compensation, because of the unique qualities of the futures industry clearing system. The futures industry uses a system of margin payments combined with daily settlement of accounts to ensure contract integrity. Initial margin is the minimum amount a market participant must deposit in his or her account in order to buy or sell a futures or options contract, and maintenance margin deposits are required on any day that debits resulting from a market loss reduce the funds in the account below the initial margin level. Daily settlement of gains and losses, through a futures clearinghouse, is the most distinguishing feature of futures and options markets - and the most vital for maintaining the financial integrity of the markets. All positions are marked-to-market every day by the clearinghouse, and daily settlement in cash or cash equivalents prior to the market's opening the next day confirms that each clearing member firm is solvent and can continue to conduct business in the market.

All reinsurance transactions at the Chicago Board of Trade also benefit from the huge financial backing provided by its clearinghouse, the AAA-rated Board of Trade Clearing Corporation (BOTCC). The BOTCC, which is a separate entity from the CBOT, ensures the total

integrity of the market by acting as a third-party guarantor to each transaction performed at the Board of Trade. In addition, the BOTCC plays an integral part in market transactions. As described above, its roles include, among others, the daily matching of trades, as well as collecting and holding margins which are financial guarantees required from both buyers and sellers to ensure that they fulfill their trade obligations. In short, the third-party guarantee of the clearinghouse draws great strength from a clearing system that has been in place and has evolved over many years. For over seventy years, no customer of a clearing member has ever lost money due to a default under the clearing systems used at the Chicago Board of Trade.

In short, the CBOT catastrophe contracts are standardized instruments that track the industry catastrophic loss results during a specified time period and allow companies to insure themselves against a self-determined level of loss. Investors from the capital markets are interested in taking on the risk of that loss in hopes of a profit. In order to maximize the benefits of the coverage received at the Chicago Board of Trade, an insurance company must compare its catastrophic regional or state exposure with that of the industry and adjust the amount of protection needed appropriately. An insurance company must first determine the appropriate level of coverage needed by relating its attachment points to that of the industry and also assess the amount of coverage needed by calculating the proper amount of contracts needed.

Although reinsurance capacity channeled through the CBOT remains small to date (about $80 million since September 1995), it is growing rapidly. Open interest in the PCS catastrophe insurance options (which can be used as a measure of the capacity handled through our market) has grown by 65% between 1996 and 1997. This number is even more remarkable as the traditional catastrophe reinsurance market has considerably softened over the last two years. To date, there have been transactions in all of the nine regions and states offered at the Exchange. A recent breakdown of the transactions shows that capacity offered at the CBOT was distributed across

regions and states as follows: 22% East, 16% National, 14% Midwest, 12% West, 10% California, 9.5% Southeast, 8.5% Florida, 6.5% Northeast and 1.5% Texas.

The CBOT plans to pursue its penetration into the insurance and reinsurance markets by expanding its current catastrophe product line to options based on single catastrophic events, both in the U.S. and abroad. Single-event catastrophe insurance options based on the U.S. territory are expected to be listed on the Exchange, subject to systems development, within 12 months. In addition, the CBOT also envisions listing Japanese Earthquake options.

Benefits of Market-Based Management of Catastrophe Risk

The CAT contracts offer many benefits to the insurance industry. By introducing these products, the Chicago Board of Trade has essentially securitized catastrophic risk. This works to the benefit of the insurer or the reinsurer since, at any time, they can liquidate their open positions, terminating their coverage when and if it is no longer needed. In addition, the tradeability feature has attracted new sources of capital from beyond the traditional reinsurance market by providing private investors with an opportunity to invest indirectly in the insurance industry. Investment, commodity and pension funds are interested in using the CAT contracts because these instruments provide another means to diversify their portfolio risk. The return received from selling pure insurance risk displays no correlation with returns of other asset classes, such as stocks and bonds.

Unfortunately, regulatory and accounting barriers deprive many potential users of the benefits of CAT contracts. Only California, Illinois and New York[1] have expressly addressed an insurance company's authority to engage directly in exchange-traded insurance derivatives. In

[1]The New York legislation lapsed pursuant to a sunset provision on December 31, 1996, before implementing regulations could be adopted.

each of these jurisdictions, such authority has been limited to hedging transactions. In addition, the National Association of Insurance Commissioners (NAIC) does not treat CAT contracts like reinsurance for accounting purposes. For example, if insurance companies manage their risk exposure by purchasing traditional reinsurance, they are rewarded by being allowed to increase the level of coverage they write. No such increase is granted to companies managing their risk exposure through CAT contracts, thereby penalizing companies for using CAT contract to manage their risk, and certainly discouraging a number of potential companies from utilizing these risk management tools. These are issues the CBOT and others involved in innovative insurance risk management continue to try to resolve.

As part of the CBOT's focus on these and other issues of concern to the potential market for our risk management services, the exchange is also co-sponsoring an initiative, currently dubbed the Chicago Board Insurance Exchange ("CBIE"). Last year, the Illinois Department of Insurance made available an additional license for a new Insurance Exchange. In the fall of 1997, the CBOT retained a consulting firm to explore the feasibility of establishing a new Insurance Exchange in Illinois and determined that it should seek insurance and capital market partners to create and develop a risk distribution mechanism solely for novel forms of insurance. For instance, insurance companies could lay off a risk on their books by issuing "company indemnity warranties" on the CBIE. These warrants could become divisible and tradeable in a secondary market.

The organizers of CBIE are currently evaluating what organizational structure could be created to efficiently allow risk ceders (insurance and reinsurance companies) to treat the risk posted on the CBIE as insurance, while allowing risk assumers to be members of both the insurance and reinsurance community as well as the investment community. (To date, as you may know, state insurance laws do not allow for private investors to directly handle the business of

insurance, hampering access to this pool of available capital.) In addition, if the CBIE evolves as planned, this initiative would provide an attractive alternative tax and regulatory environment to compete successfully with offshore locations, such as Bermuda, which are currently attracting such U.S. insurance business.

Conclusion

CBOT catastrophe insurance options contracts and the other exchange-based initiatives described in my testimony offer creative catastrophe risk mitigation alternatives to insurers that can supplement traditional reinsurance coverage and offer additional protection against very large catastrophes. Such contracts can be extremely beneficial to the reinsurer who can now, in a low cost manner, transfer some of his risk to the financial markets, thereby freeing resources to write additional direct catastrophic coverage to primary insurance companies. Our experience continues to demonstrate that there is a market for innovative, private market instruments to manage insurance risk, and, that there is a market of investors willing to take on that risk. By channeling additional capital sources towards the insurance industry, the Chicago Board of Trade believes it has helped enhance the worldwide catastrophic reinsurance capacity.

RAA
REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

Statement of

FRANKLIN W. NUTTER
President
Reinsurance Association of America

Before the

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING AND
FINANCIAL SERVICES

April 23, 1998

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Chairman Leach and Members of the Banking Committee, it is an honor to appear before you on behalf of the Reinsurance Association of America. We commend you, Mr. Leach, as well as Messrs. McCollom and Lazio, in particular, for your leadership in promoting legislation to address the issue of natural catastrophe exposure and insurance.

The Reinsurance Association of America represents domestic property and casualty reinsurers.[1] For many years, our members have been committed to creating an appropriate federal role addressing natural catastrophe exposure. We remain convinced that federal involvement is a necessary component of any ultimate solution.

THE PRINCIPLES OF NATURAL DISASTER POLICY

The reinsurance industry has maintained a consistent position on the need for high-level federal involvement in excess of private market capacity. Catastrophe insurance and reinsurance coverage otherwise should be preserved for private sector carriers. State catastrophe funds should only be employed as a last resort.

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[1] Often described as "the insurance of insurance companies," reinsurance is a sophisticated transaction by which one insurer indemnifies, for a premium, another insurer against all or part of a loss that it may sustain under its policies. The fundamental objective of insurance, to spread risk of loss, is thereby enhanced by the insurer's ability to spread that risk further through reinsurance.

Illustrative of that risk spreading function, roughly two-thirds of all catastrophe reinsurance for risks in the U.S. is provided by off-shore sources.

The primary purposes of reinsurance are to: (1) limit liability on specific risks; (2) to stabilize loss experience; (3) to protect against large losses; and (4) to increase capacity. Each of these uses is reflected in insurers' purchase of reinsurance for protection from catastrophic natural disaster losses, though the degree to which each insurer will utilize reinsurance for one or all of these purposes is determined by each insurer after assessing its own exposure to losses and its own capital resources.

That position is rooted in the following principles, which we urge the Committee to adopt as its own:

(1) natural catastrophe exposures, hurricanes and earthquakes, are insurable risksin the private sector;

(2) government's role should be to address insurer solvency in the event of a mega-catastrophe, hereby fostering private sector coverage and preserving the claims paying ability of insurers;

(3) the risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs;

(4) the private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal;

(5) the government should encourage, and -- where appropriate -- fund pre-disaster hazard mitigation efforts; and

(6) any federal proposal should address personal and commercial lines,[2] since both forms of coverage are affected by catastrophic events.

Those principles form the basis for the RAA's evaluation of all disaster-related legislation, whether they be federal or state proposals. They are founded solidly in the belief that the private market is the appropriate bearer of catastrophic risk, but are tempered by the recognition that a natural event could occur, one greater than any which has occurred to date, which exceeds the resources of the U.S. insurance and global reinsurance industries.

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[2] Questions often arise about distinctions between reinsurance for commercial or residential exposures. Property catastrophe reinsurance customarily does not make such a distinction unless the reinsured company is principally an insurer of one class of business or the other, or otherwise seeks reinsurance for only one type of exposure. The most common form of property catastrophe reinsurance is "excess-of-loss," whereby the reinsurer assumes the loss excess of some loss experience of the reinsured – whether commercial or residential coverage.

HOW CAPACITY IS PROVIDED

At the outset, it is critical in evaluating the capacity of the industry that the Committee keep in mind that insurance capacity for natural catastrophe exposures is provided by insurers and reinsurers, but the bulk of the catastrophe risk is retained by primary insurers who provide coverage directly to the public. Reinsurers provide protection for insurers in the face of large catastrophe losses but our segment of the industry, by premium volume or surplus, is roughly one-tenth the size of the primary insurance industry. Although reinsurers bear a significant portion of catastrophe losses, several of the largest national personal lines insurers, for example, purchase little, if any, reinsurance, because their resources, as reflected in their capital and surplus, are large enough to retain risk and absorb shock losses. A smaller or regional insurer, however, may rely on reinsurance to spread its risk of loss. No insurer should, or wants to, expose its entire capital base to the threat of a single natural catastrophe or an accumulation of catastrophes. In addition, insurers have a responsibility to stockholders or, in the case of mutual insurers, policyholders, to see that their capital provides an adequate return on equity and is not exposed to a risk of ruin from natural catastrophes.

DEVELOPMENTS IN CATASTROPHE INSURANCE MARKETS

Fortunately, since the early 1990s, many positive developments have occurred which demonstrate that, working with state government, private insurance markets have been resilient to major catastrophe losses and have dramatically improved their ability to absorb catastrophe risk:

- As an industry, and for the major insurers of catastrophe exposure, capital and surplus, the cushion that absorbs shock losses from catastrophe risk, has nearly doubled since the end of 1991. This time period includes the payment of claims from the two largest privately insured catastrophes in our Nation's history, Hurricane Andrew ($15.5 billion) and the Northridge Earthquake ($12.5 billion). Industry surplus at year-end 1991 was $158.7 billion. At the end of 1997, the surplus was $311 billion.

- Most, if not all, insurers have taken steps to better assess their catastrophe exposure and put in place programs that mitigate the risk of financial impairment to their companies. These steps have included the establishment of subsidiaries devoted exclusively to high-risk markets, better management of the utilization of reinsurance, use of new capital markets products and special purpose vehicles (discussed below), and catastrophe modeling to better evaluate exposure and establish premium levels commensurate with the risk.

- New capital markets products have been developed and implemented in the last few years to securitize insured catastrophe risk and provide additional capacity to insurers. (See Appendix A for specific examples.) Some of the Nation's most prominent investment banking and securities organizations have actively securitized insurance catastrophe risk, including the Chicago Board of Trade, Goldman Sachs, Morgan Guaranty Trust, J.P. Morgan Securities, Credit Suisse First Boston, AON Re Services, and Sedgewick Lane Financial. In 1997, $1 billion of such transactions took place. These firms report high expectations for expanding this market exponentially to fill capacity needs above that available in the insurance and reinsurance industry.

- Reinsurance capacity has increased dramatically in the last five years and, as a result of a very competitive marketplace, prices have dropped. (See Appendix B.) A study of actual excess-of-loss catastrophe reinsurance contracts in place by Swiss Reinsurance Corporation shows approximately $18 billion of catastrophe reinsurance covering U.S. risks. Following a dramatic rise in reinsurance catastrophe prices in 1992 and 1993, prices are now nearly at the original pre-Hurricane Andrew rates. The Swiss Re study does note, however, that on the basis of a one-in-one-hundred-year earthquake or hurricane loss, insurers are generally under-reinsured and that capacity is widely available.

- State insurance departments have been working with insurers to allow changes in policy coverages and premiums that bring premiums in line with the risk of catastrophes in their markets and give consumers options in line with their resources.

Together, the above developments have done much to address consumer level concerns about the availability and affordability of catastrophe insurance and have provided additional security to insurers against the threat of financial impairment. Evidence of this is best reflected in the recent report on coastal insurance issued by the State of New York, citing increases in the number of coastal homeowners policies in the voluntary insurance market; an increase in the number of agents and brokers servicing that market; a decline in writings by the New York Property Insurance Underwriting Association (a state-mandated market to ensure availability); and an increase in the number of insurers that are servicing the New York coastal market.

Florida Insurance Commissioner Bill Nelson has also noted that 22 private insurers, most of them new to the Florida market, have removed 750,000 policies from the state-run Joint Underwriting Association, bringing the JUA below 400,000 policies for the first time since April 1994. This is a clear sign of a recovering private market.

Policyholders and others exposed to natural catastrophes may, in some areas, still be facing coverage and pricing issues, thereby prompting this important hearing, but the marketplace is exhibiting extraordinarily positive signs with regard to its ability to insure the risk of natural catastrophes without threatening their own financial position.

THE FUNDAMENTAL PROBLEM

Notwithstanding these positive developments, a fundamental problem facing insurers and their policyholders remains: the threat of a mega-catastrophe that exceeds the resources of the insurance and reinsurance markets. An insured catastrophe that, for example, exceeds 15 percent of the aggregate surplus of the industry could have a significantly negative effect on the industry's ability to continue to provide coverage. A study being conducted by The Wharton School at the University of Pennsylvania entitled, "Managing Catastrophe Risks," states that preliminary estimates (based on 1996 figures) indicate that insurer insolvencies begin at shock levels of around $45 billion in insured loss.

The best approach to address this problem is straight forward:

- Consumers who live in catastrophe-prone areas should pay a premium for insurance in direct relationship to that risk and be given coverage options that allow them to evaluate the level of risk they choose to retain on their own account;

- States and communities working with the federal government should institute pre-disaster mitigation programs, including appropriate building codes and hazard reduction measures; and

- At the federal level, a safety net providing protection for insurers above which they cannot absorb catastrophe losses should be put in place.

With these measures, private sector competition and capacity will continue to flourish, damage to homes and lives will diminish and, in the case of a mega-catastrophe, the financial infrastructure of the industry would remain intact, thereby averting wide dislocations throughout the economy. This combination of state regulatory action and federal legislation will solve this problem.

EVALUATION OF PROPOSED FEDERAL APPROACHES

It has been suggested that the two bills introduced in Congress, HR 219 and HR 230, as well as the Housing subcommittee bill (also designated as HR219) are similar approaches. In fact, HR219 and HR230 take fundamentally differing approaches, both in scope and structure. HR 219, the Homeowners Insurance Availability Act of 1997, would provide federal government reinsurance to state government-sponsored catastrophe funds once losses exceed the greater of funds' claims-paying capacity[3] or $2 billion, or, in the case of new state programs, $2 billion or the greater of the

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[3]The CEA capacity is estimated at $10 billion in residential insured losses. The Florida Hurricane Relief Fund is estimated at $12 billion in residential losses.

one-in-one-hundred-year event. HR 230, the Natural Disaster Protection and Insurance Act of 1997, would authorize Treasury to auction excess-of-loss bonds to public and private catastrophe risk-bearers, insurers and state funds, which would pay pre-determined amounts in the event of losses that exceed $10 billion.

In comparing the two approaches with our principles, HR 230, with a higher threshold than $10 billion, meets the principles of the private market solution we previously stated. We urge the Committee to adopt this approach.

Structural Incentives: The fundamental distinction between the two proposals is the structural incentive each provides for addressing catastrophe exposures. HR 219, by providing reinsurance to state-operated government entities, encourages more state government, taxpayer-subsidized solutions. If this government program to government program approach is adopted, states will be pressured by strong incentives to create new funds or restructure existing state authorized insurance pools to qualify for the federal reinsurance. Private insurers will transfer catastrophe risk to state government, taxpayer-financed funds, which in turn will transfer that exposure to federal reinsurance.

It has been suggested that state funds are cheap reinsurance. This is misleading. While a state fund such as in Florida probably does underprice the private reinsurance market up-front, it is predicated on surcharges of policyholders after the catastrophic event. The Florida Insurance Department regularly points out that in the event of significant losses to the Florida Catastrophe Fund, consumers would be subject to heavy surcharges. "If hurricane losses reach $20 billion, all Florida homeowners could suddenly face a 40 percent increase in their insurance bill in the first year after the storm...," press release February 12, 1998. If in California, the Earthquake Authority is unable to pay all claims, it must, by law, pay claimants a percentage based on available funds.

Don't be mislead: it is "pay now or pay later."

In addition, federal reinsurance must be purchased, which, unless subsidized, most certainly will necessitate increases in consumer premiums

HR 230, in comparison, would auction bonds to all risk-bearing entities, thereby supporting private as well as public solutions. Indeed, it is likely that a new insurance futures market providing welcome additional capacity would be developed based on the model of the federal excess-of-loss contract. In addition, the excess of loss contracts will serve as vehicles for insurers and reinsurers to create a secondary market for small or regional companies.

This structural distinction, then, while seemingly philosophical in nature, has major implications for the long-term development of the homeowners insurance marketplace, as well as for the role of government in insurance markets generally. **HR 219 will encourage the greater intrusion of state government into the private insurance market, while HR 230 will encourage the expansion of private market insurance.** Federal excess-of-loss contracts will free capital of reinsurers and insurers to serve capacity needs at lower capital levels.

Triggers: Another provision of the two bills that should be addressed is the point at which each proposal would have the federal government begin paying on its obligations. HR 219 sets that point at whatever the claims-paying ability of the state fund is determined to be (though $2 billion and $10 billion of residential insured loss are specifically referenced in the bill); while HR 230 sets $10 billion as the trigger point at which the U.S. Treasury would begin reimbursing bond-holders.

Both triggers fall below the actual residential and commercial claims paid by industry for our Nation's largest insured losses: Hurricane Andrew at $15.5 billion and the Northridge, California, Earthquake of 1994 at $12.5 billion. **In short, both triggers significantly underestimate private insurance capacity, and both would likely lead to a major dislocation of private market capacity in favor of federal capacity**, particularly if done at subsidized rates. Furthermore, by virtue of the fact that states can essentially define their own triggers under HR 219, such a standard would undoubtedly lead to the maximization of risk-shifting to the federal government, or the

abandonment of private sector financing for state funds (such as the reinsurance and capital market layers of the California Earthquake Authority).

The Committee should consider a conservative rule of thumb often referenced in the private market:

- Insurers retain catastrophe losses in the normal course of business of five percent of industry surplus ($311 billion) or $15.5 billion

  plus

- Risk transferred to reinsurers of another five percent or $15.5 billion (this is appropriate for most insurers to transfer; large, highly capitalized insurers would retain this limit).

  plus

- For the further development of capital market products (add an additional two percent of industry surplus or $6 billion).

Therefore, an appropriate "trigger" (including residential and commercial coverage) would be $37 billion as of year-end 1997. By using surplus, the trigger adjusts based on the financial experience of the industry.

When one considers the totality of losses that typically occur in the event of natural catastrophes, including residential losses and commercial losses, the RAA is optimistic that a trigger level can be developed that provides significant assistance to state funds and insurers, yet does not displace private sector resources.

State Auction of Reinsurance: HR 219 was amended at the subcommittee level to include a program whereby states would purchase federal reinsurance and auction it to insurers. We believe that the

State Auction of Reinsurance: HR 219 was amended at the subcommittee level to include a program whereby states would purchase federal reinsurance and auction it to insurers. We believe that the objective of this proposal is to ensure that small insurers have access to federal financial support, however, we know of no constituency for this state auction concept. Whether states have the legal authority or the desire to do this is a question the Committee should ask. How Treasury would price this on a state-by-state basis is unclear and what happens with contracts not purchased by insurers at a state auction is also a major issue. In addition, it would be a mistake to compromise the total capacity by parceling it out. The goal of serving smaller insurers should, perhaps, be best left to administrative determination pursuant to the targeted auction of excess of loss contracts, or the secondary private market that will definitely develop..

Beware The Risk Shifting Game: The RAA believes that HR 219 could actually dilute the finite amount of proposed federal reinsurance capacity or require additional federal reinsurance capacity due to its incentives for the creation of more state funds. As more state funds are created, as they inevitably will, the federal capacity would get shared among more buyers, thus making it less valuable to the three existing funds. Pursuant to HR 219, qualifying state funds could structure themselves so that the federal reinsurance is accessed at lower loss amounts, thereby shifting substantial exposure onto the federal reinsurer and lessening reliance on the private sector; while creating a moral exposure due to the solvency risk created by the single-event nature of the qualifying funds.

In terms of the potential consequences of HR 230, it is clear that a new federal exposure to natural catastrophes would be created, but that would also be funded through the auction price. That auction process, as highlighted earlier, should facilitate the creation of a new private catastrophe futures market, thereby focusing creative thought and capital resources on developing innovative private sector financing techniques, rather than fostering a dependence on state government insurance programs. In sum, it better utilizes private sector resources and approaches.

Most importantly, though, a high-level threshold for catastrophe bonds provided for by HR 230 would diminish the threat of insurer insolvency from a major catastrophe, prompting them to write more residential and commercial coverages in disaster-prone areas.

Federal Insurance Regulatory Oversight: Together, more state funds, low triggers for federal reinsurance, and the requirement that Treasury underwrite each state fund based on risk covered and the prices being charged to consumers, will require policy makers to create some form of regulatory oversight mechanism. This federal regulatory entity would have to make an evaluation of underlying insurance rates charged to consumers (required by HR 219 to be actuarially sound), and oversee solvency of state funds. It should also be mentioned that a federal reinsurance administration will be necessitated in order to underwrite the reinsurance, establish rates and pay claims.

CLOSING REMARKS

The RAA principles on natural disaster legislation are rooted in the belief that capitalistic incentives, operating within a flexible regulatory environment, provide ample motivation for the private sector to offer homeowners and commercial insurance in disaster-prone areas. However, they also recognize that the inherent nature of the risk associated with that coverage creates a high-level capacity void that only the federal government can fill.

Those principles are further strengthened by a marketplace that is improving with each passing day: more companies are writing more coverage; technology is improving insurers' ability to underwrite accurately; and new forms of reinsurance and capital market products are altering the complexion of catastrophe risk management.

Combine these dynamic developments with the guidance being exhibited by Congressional leaders such as yourselves, and I am optimistic that we are approaching a private/public partnership that

will help ensure the availability of homeowners and commercial insurance to consumers in disaster-prone areas, while properly maximizing the resources of the private sector.

I urge you to support the minimum level of federal government involvement necessary to maximize the resources of private insurers, as reflected in HR 230 with a higher trigger.

I thank you for this opportunity to testify, and I welcome any questions you might have.

Attachment A

SECURITIZING NATURAL DISASTER RISK

Nationwide - Nationwide has the option to issue up to $400 million of 9.222% surplus notes to fund new business opportunities or as reimbursement to catastrophic losses. Contract with Morgan Guaranty Trust Company. (1995)

State Farm - A $3 billion revolving credit facility has been set up for State Farm to cover catastrophe losses. The deal was arranged by J. P. Morgan Securities, Inc. (1995)

Arkwright - Arkwright has set up a trust to issue $100 million in trust notes to private investors. New proceeds of the notes will be used to buy government securities held by the trust. (1996)

AIG Combined Risks/Benfield - Placed 5 catastrophe-linked bonds with an investment fund managed by Mercury Asset Management. Bonds will pay out if a catastrophe exceeding an agreed trigger occurs in: U.S., Japan, Australia, Caribbean, Europe or Japan. (1996)

Hannover Re - Sold $100 million worth of catastrophe cover. The portfolio-linked swap is comprised of the following: Japanese earthquakes, U.S. natural catastrophes, Canadian natural catastrophes, North European storms, North European other catastrophes, Australia - all catastrophes and aviation excess-of-loss. (1996).

St. Paul Re - $68.5 million deal through Goldman Sachs & Co. to increase capacity. St. Paul Re will cede reinsurance business from five classes under a 10 year reinsurance treaty. Investors participate in excess-of-loss underwriting by investing in bonds or preference shares. Enables St. Paul to increase capacity in 5 excess-of-loss classes: U.S./Caribbean property-casualty, European property-casualty, other property-casualty, retrocessional/Lloyd's short-tail and marine and aviation. (1997)

Winterthur Swiss Insurance Group - Placed $282 million of catastrophe bonds in private capital market. The bonds cover Winterthur exposure to auto claims stemming from domestic summer hailstorms. Transaction managed by Credit-Suisse First Boston. (1997)

Swiss Re - Placed $137 million in two-year bonds tied to reinsurance losses from a potential California earthquake. Swiss Re and Credit Suisse First Boston were the placement agents for the notes. (1997)

Horace Mann Educators Corporation: Agreement allows Horace Mann to receive up to $100 million from Center Re, the transactions underwriter, in exchange for an equivalent value of its convertible preferred shared in the event of a mega-catastrophe. (1997)

RLI Corporation - Aon Re Services developed a $50 million catastrophe equity put (CatEPut) for the RLI Corporation. The deal was underwritten by Centre Re. In the event of a catastrophe which exhausts RLI's traditional reinsurance coverage, the CatEPut program allows RLI to sell up to $50 million in preferred shares to Centre Re. (1997)

USAA - USAA placed $400 million of hurricane bonds in the private placement market. The bonds will provide USAA with an excess-of-loss cover tied to a single hurricane producing losses of more than $1 billion during a one-year reinsurance period. The offerings syndicate managers were Merrill Lynch & Co., Goldman Sachs & Co. and Lehman Bros (1997).

LaSalle Re - Aon Re, Inc. and Aon Securities Corporation developed a $100 million multi-year Catastrophe Equity Put (CatEPut) option program for LaSalle Re. The option program allows LaSalle to issue up to $100 million in convertible preferred shares in the event of a major catastrophe or series of large catastrophes that result in substantial losses to LaSalle Re. (1997).

Reliance National Insurance Company - Completed a $40 million securitization of non-catastrophe coverage for its property, aviation, marine drilling and satellite launch exposure. The placement ties bond payment trigger points to a catastrophe index established by Swiss Re. Sedgewick Lane Financial structured the deal (1997).

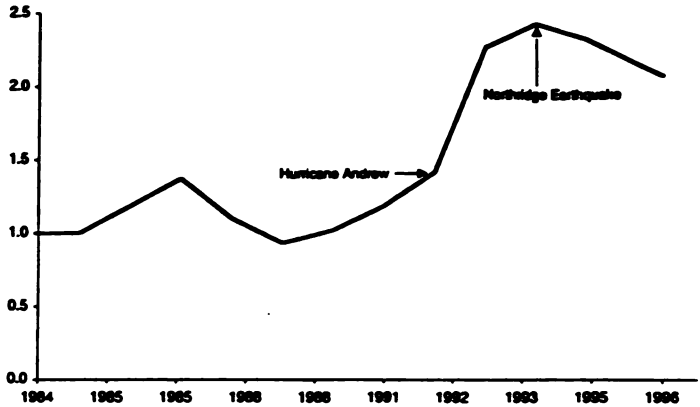
Allstate Insurance Co. - Allstate announced a plan to form a second Florida-only subsidiary to help depopulate the Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA). The new subsidiary is expected to assume most of a plan to remove 49,000 policies from the FRPCJUA. The remaining policies will be assumed by Allstate's existing Florida-only subsidiary. Allstate Floridian (1997).

Centre Solutions - Completed an $83.5 million transaction, whereby it retrocedes that amount of coverage to Trinity Re. a specialty purpose reinsurer, which in turn securitizes the coverage into two bond offerings. The transaction provides high level protection to a Florida-only startup insurer, and is triggered by a Florida hurricane which causes the company to sustain over $45 million in losses.

Prepared by RAA. April 21, 1998

Attachment B

PARAGON CATASTROPHE PRICE INDEX, 1984 - JULY 1996



Attribution: Paragon Reinsurance Risk Management Services, Inc.

STATEMENT BY

ISOLDE O'HANLON

MANAGING DIRECTOR
CHASE SECURITIES, INC.
270 PARK AVENUE, 20TH FLOOR
NEW YORK, NEW YORK 10017
(212) 270-5289

ON

H.R. 219 THE HOMEOWNERS' INSURANCE AVAILABILITY ACT

BEFORE THE

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

APRIL 23, 1998

Mr. Chairman, Thank you for the opportunity to address the Committee on proposed legislation (H.R. 219) that deals with what recent history has shown to be of extreme importance to our country, the impact of catastrophic events.

Chase has been a leading provider of financing and advisory services to the insurance industry and the original provider of financial products to fund catastrophic property insurance risk. We have served as an underwriter and provider of capital, liquidity and advice to the Hawaii Hurricane Relief Fund, the California Earthquake Authority, and the Florida Windstorm Underwriting Association. These pioneering programs operating at the state level helped to restore and ensure the continued availability of residential property insurance.

Given its experience, Chase has a unique perspective on the roles of state and Federal government in the private insurance market. My comments today will focus on the following five areas 1) the degree to which state programs hinder voluntary market opportunities, 2) the limits on capacity of private capital and reinsurance markets to satisfy catastrophic exposures, 3) the appropriateness of the state retention level at a one in one hundred year event, 4) the differences in commercial insurance exposure to catastrophic events as compared to personal insurance and 5) the differences in pricing rationale between primary insurers and reinsurers.

Chase has been actively involved in Florida, California and Hawaii. Each of these geographic locations experienced severe catastrophic events in the early 1990's which caused disruption in their voluntary markets. In 1992 Hurricane Iniki caused $1.6Bn of insured losses in Hawaii. In response, the Hawaii Hurricane Relief Fund was established by the State Legislature and Insurance Department in 1993 for which Chase arranged a $500MM bank liquidity facility in 1994. The California Earthquake Authority was created in response to the Northridge earthquake which caused $12.5Bn in losses in 1994. The CEA utilized Chase to secure a $700MM bank facility to increase its claims paying resources at the beginning of 1997. The Florida Windstorm

Underwriting Association was formed in 1970 to provide coverage for exposure to losses caused by windstorms in Monroe County which includes the Florida Keys. After the $16.2Bn in losses caused by Hurricane Andrew in 1992, the Association has been greatly expanded to include portions of 29 of Florida's 35 coastal counties. In 1997 Chase underwrote $750MM in pre-event notes for the Association and increased the bank liquidity facility to $1.75Bn. In each of these situations the establishment of a new fund or the expansion of an existing program helped to stabilize the market in the short to medium term. Following an event, state funds provide a critical role by supplying liquidity to the market as well as stabilizing pricing in a volatile environment. As this suggests, the state programs are a necessary tool in areas subject to catastrophic exposure in the short to intermediate term. In the states which employ these programs we have seen a return of insurance coverage to the private market after a stabilization period as evidenced by the reduction of policies in the Florida Residential Property and Casualty Joint Underwriting Association, during the past two years. It should be noted that the policies provided by these programs must be priced at actuarially sound levels and not at levels intended solely to decrease overall premium levels by providing "subsidized" coverage. If prices are not set at sound levels the result would clearly be to hinder the private market with the taxpayer footing the bill.

When assessing the need for any type of governmental program, an obvious prerequisite is to ensure that the private markets cannot provide the service before looking to the government to become a provider. In this case the analysis suggests an assessment of the capacity of the reinsurance and capital markets to provide capital for the support of catastrophic events. With respect to the insurance industry there are two factors which constrain the level of support that the industry can provide: the absolute amount of capital available to support catastrophe losses and the risk appetite for exposing capital to areas subject to very large catastrophic losses. The reinsurers which provide most property catastrophe reinsurance, for example, are located in Bermuda. At the end of 1997 the total capital of these companies was slightly greater than

$6Bn. As a comparison, that capital is less than half of the $16.2Bn of insured losses from Hurricane Andrew in 1992 or the $12.5Bn in losses from the 1994 Northridge earthquake.

The recent increase in the real estate development in coastal and other catastrophe prone areas has caused the potential for loss in these regions to grow exponentially. In order to avoid excessive exposure to one particular catastrophic event, reinsurers create geographic or zonal limits to the amount of coverage that they provide. The limit is typically set to ensure that a single catastrophic event will not deplete a specified portion of the reinsurers capital. The increase of exposures in certain areas has created a larger disconnect between the needed level of coverage in certain areas and the ability to buy coverage at desired price or premium levels. The Hawaii Hurricane Relief Fund, for example, can purchase reinsurance coverage well in excess of its 1 in 100 year event of $650MM; the Florida Windstorm Underwriting Association will see a marked decrease in supply as it approaches its 1 in 100 year event of approximately $5.0Bn. There is clearly a very important role for reinsurers, but they cannot provide a solution for all aspects of catastrophe protection.

The capital markets began providing capital to finance losses from catastrophes in 1994 with a $500MM bank facility for the Hawaii Hurricane Relief Fund. Since then over $10Bn in catastrophe-liquidity has been provided by the capital markets. The form of the capacity provided by the capital markets has progressed from revolving bank liquidity facilities to the broader public market with notes that provide liquidity capital. Most recently, risk transfer products have been offered which move beyond providing liquidity capital to providing capital that will bear the risk of catastrophic events with securities commonly referred to as CAT bonds. It is important to note that although these risk transfer products have great potential to provide capacity, the market is clearly in its early stages of development with a total of only 60-80 investors. As capital market products continue to evolve and grow, we will see increased benefit to the areas that need additional capital to support large catastrophic event

claims. Reinsurers and the capital markets both provide substantial capital to the programs that operate in Florida, California and Hawaii. The most recent data available indicates that over $3.0Bn in coverage is provided by reinsurers for these programs and almost $6.0Bn in capital is available from the capital markets to provide liquidity for the programs to quickly pay claims. However, it is essential to note that investors providing this capital require a sufficient return on their investment. This applies to equity invested in a reinsurer as well as to an investment in a bond with returns linked to the occurrence of a catastrophic event. It is our belief that due to this required return by all investors in the capital markets, capacity will still be needed to support extremely low frequency, high severity occurrences.

The obvious question then becomes: What is the breaking point that defines an "extremely low frequency, high severity event"? And is the level of a 1 in 100 year event that H.R. 219 suggests that breakpoint? This level, referred to as the 100 year probable maximum loss, will vary greatly across regions and among states based primarily on the value of the development and the probability of a catastrophic event in that region. For example, the losses incurred due to a 1 in 100 year event for southern Florida because of weather and development will be many times greater than the losses incurred due to a 1 in 100 year event for Wyoming. This measure, however, is the standard tool used by agencies that rate insurers and for that reason it has become a level to which most insurers and reinsurers will protect themselves.

As do the existing state programs, the proposed legislation (HR 219) only deals with personal or homeowner's insurance and not commercial property insurance. There are good reasons for not including commercial property insurance in this type of support. Historically, there have not been severe capacity problems in the commercial property insurance market, and commercial entities have greater financial resources than residential policyholders. In addition, commercial property has not experienced as great a share of the financial losses caused by catastrophic events. A recent study by Insurance Services Office, Inc. showed that

commercial losses made up only 27% of the catastrophe losses experienced in the first quarter of 1998. There does not appear to be a critical need for additional capacity for the commercial property policyholders.

The final point that we would like to comment on is the degree to which primary insurers and reinsurers differ in their approach to pricing policies. In both instances the insurer or reinsurer will need to price its policy to fully cover their expected losses and administrative costs and ensure that a sufficient profit is made for their shareholders to compensate for the risk that they have taken. The main difference deals with the differing levels of variation or volatility of the respective companies earnings. Primary insurers provide coverage that has a greater amount of predictability when compared to reinsurers. The reinsurers which provide support for catastrophic events will experience periods of high profitability when catastrophic events are few and will experience periods with losses when catastrophic events are great in number or magnitude. A basic tenet of finance is that investors need to be compensated for greater volatility of returns. Reinsurers must incorporate this element of the return required by their investors into the prices that they charge their customers.

As the amount and the sources of private capital to support catastrophic events continues to increase, we believe the need will remain for a source of capital to provide liquidity and price stabilization in the event of mega-catastrophe. This capital will serve two primary purposes. It will first provide a stable supply of coverage for highly variable, remote events, and in the event of a catastrophe, the capital will serve as a source of liquidity for the short to intermediate term to allow the private voluntary market to stabilize.

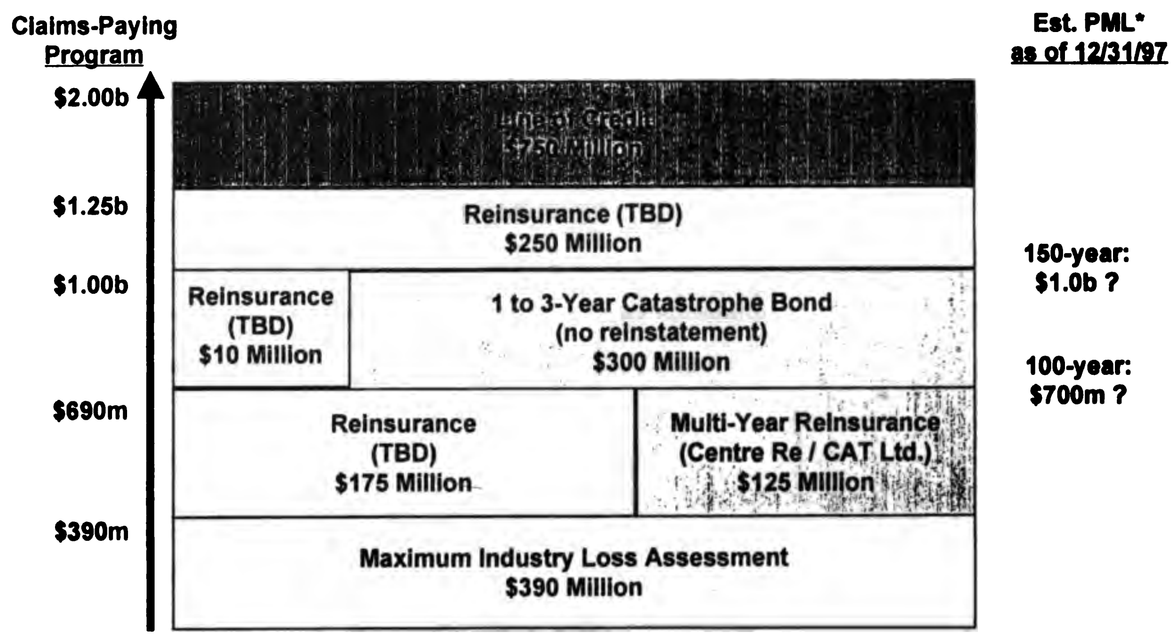
Thank you for this opportunity to provide testimony.

HAWAII

Hawaii Hurricane Relief Fund (HHRF)

- Hurricane Iniki (1992) caused $1.6b insured loss
- HHRF established 1993 by State Legislature and Insurance Department
- Governed by an Advisory Board composed of business and industry leaders
- Operated by State Department of Commerce
- No government funding or liability
- Hurricane insurance on residential and small commercial property
- Main provider of hurricane insurance in Hawaii
- Extensive assessment authority over property insurance market
- Assessment authority may be pledged to borrow funds or issue bonds

HHRF - 1998 Claims-Paying Program Alternative #1



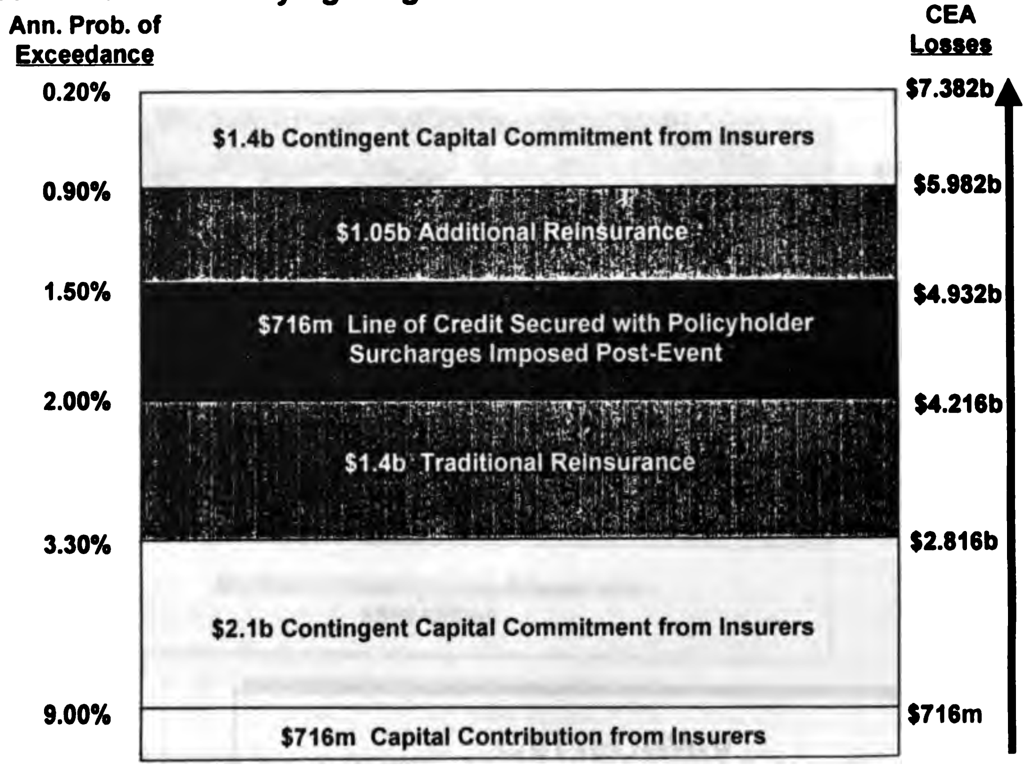
* PMLs are estimated as of 12/31/97 including demand surge and LAE. Drawing not to scale.

CALIFORNIA

California Earthquake Authority (CEA)

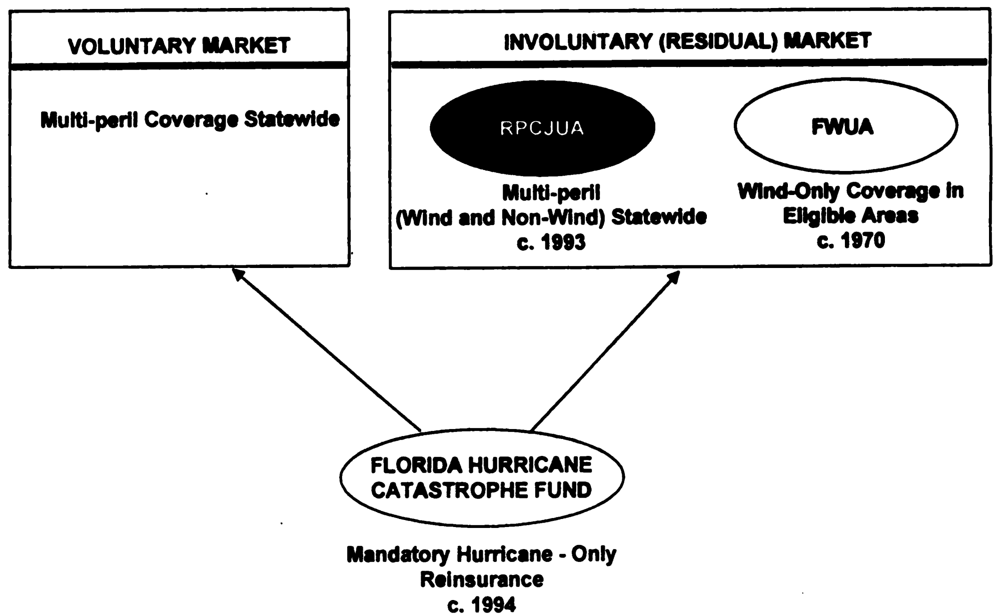
- Sponsored and operated by Department of Insurance
- Started operation in December 1996 with \$700m in capital contributions from Participating Insurers
- Investment earnings exempt from taxes
- Insurers representing 70% of earthquake market participate in the CEA
- Authority to borrow and purchase reinsurance
- Assessments and surcharges limited to CEA policyholders
- Maximum program liability \$7.35b
- No public or government liability

CEA - 1998 Claims-Paying Program



FLORIDA

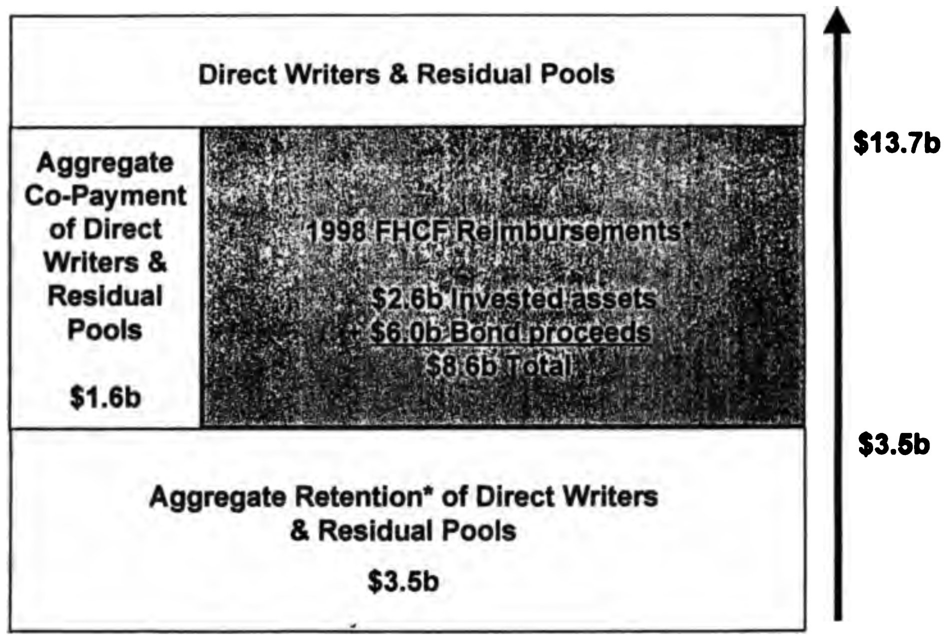
Florida's Residential Property Insurance Market



Florida Hurricane Catastrophe Fund (FHCF)

- Tax-exempt reinsurance fund established in 1994 by the Florida State Legislature
- Governed, staffed and operated by State of Florida
- Liability limited to fund balance and ability to issue revenue bonds - no state liability
- Purchase of FHCF coverage required for all licensed insurers
- Coverage for 45%, 75% or 90% of residential losses in excess of trigger
- Estimated 1998 statewide premiums: $486m
- Equivalent statewide rate-on-line: 5.7%
- De minimis claims experience to date. Fund balance $2.57b for 1998 due to premium and investment income accumulation.
- Authority to assess insurers up to 4% of prior year's direct written premium to repay bondholders
- Aggregate limit of $8.57b based on fund balance ($2.57b) and estimated bonding capacity ($6.0b)

State of Florida - 1998 Claims-Paying Program
The Role of the FHCF

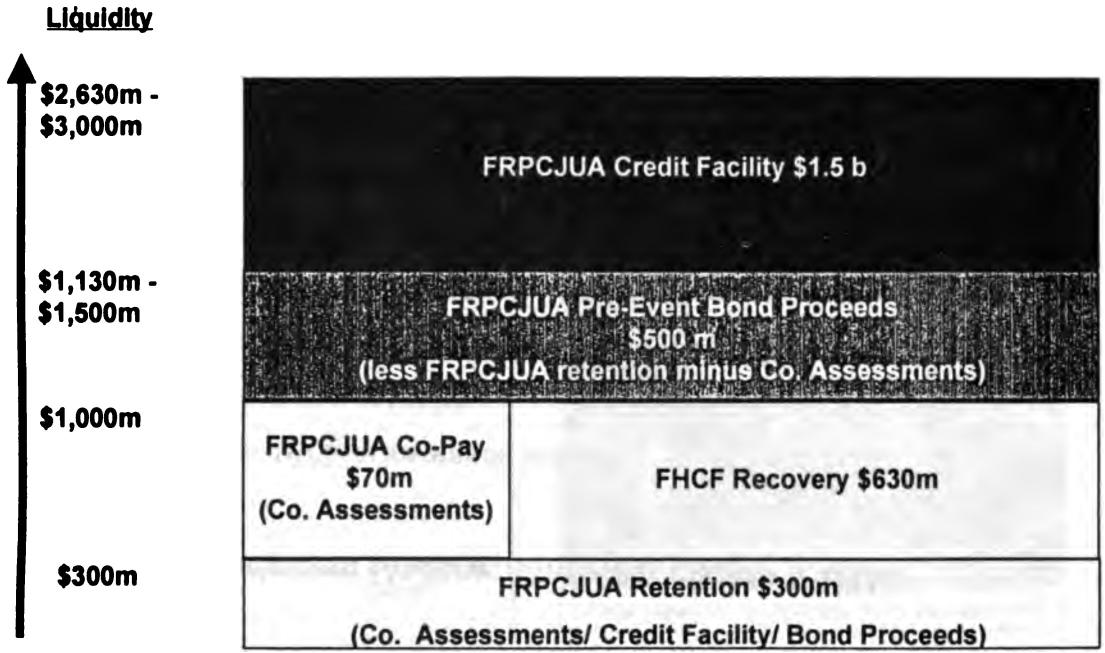


* FHCF Reimbursements are based on the losses of individual companies and are not based on aggregate Industry losses.

Florida Residential Property and Casualty Joint Underwriting Association (FRPCJUA)

- § Formed in 1993 by Florida Department of Insurance
- § Organized and operated by Florida regulators
- § Multiple-peril with wind coverage - statewide for residential property only
- § Can not write wind coverage in FWUA-eligible areas
- § Peak policy count 950,000 - currently 384,000

FRPCJUA - 1997 Claims-Paying Program



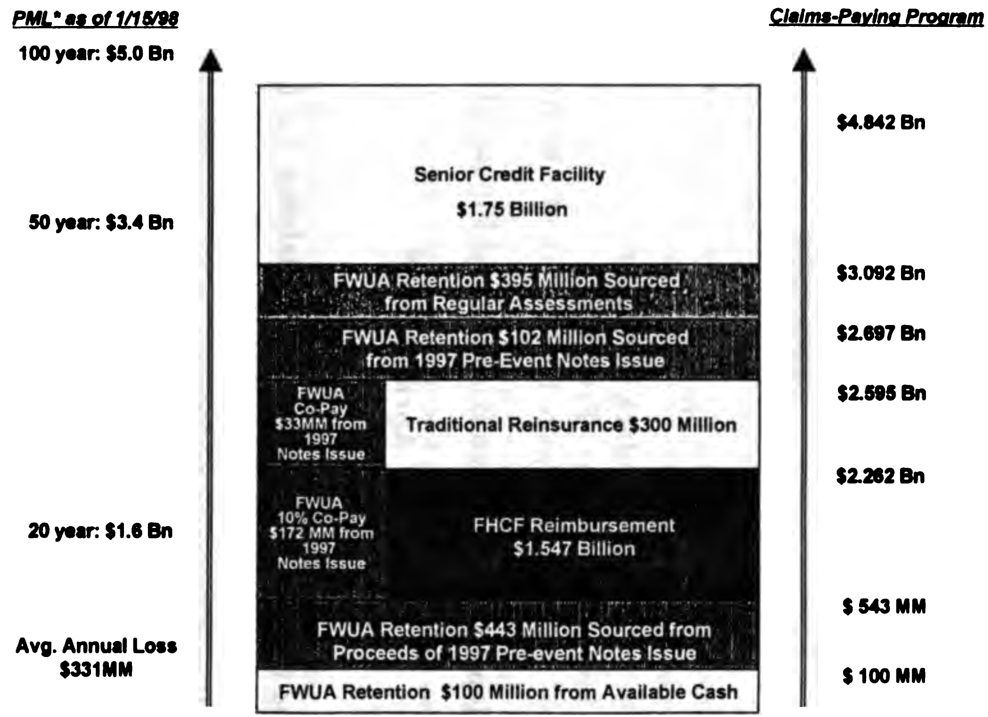
Approx. PML

100 year: $4.3b

Florida Windstorm Underwriting Association (FWUA)

- Formed in 1970 by insurance industry
- No state funding or liability
- Participation in FWUA mandatory for all licensed insurers
- Insures windstorm peril only
- Writings originally limited to the Florida Keys
- Rapid growth after Hurricane Andrew
- Now has > 50% market share in authorized areas
- Insurance industry directly responsible for initial funding of all losses until 1994, when assessment authority was granted to permit direct surcharge of policyholders across the state

FWUA - 1998 Claims-Paying Program & Funding Need to 100-Yr. PML*



*PMLs excluding demand surge, including 5% LAE. Drawing not to scale.

HOME INSURANCE FEDERATION OF AMERICA

Testimony of

Jack F. Weber
President
Home Insurance Federation of America

House Committee on Banking and Financial Services

April 23, 1998

regarding

The Homeowners Insurance Availability Act (H.R. 219)

Good Morning Mr. Chairman and distinguished members of the Banking and Financial Services Committee. My name is Jack Weber and I am President of the Home Insurance Federation of America. Our members include Allstate Insurance Company, The Farmers Insurance Group, SAFECO Insurance, the Independent Insurance Agents of America and Met Life Property and Casualty. Together, HIFA members either sell or service the majority of homeowners insurance policies in force throughout the United States. We are also the only industry organization committed exclusively to the challenges of the homeowners insurance marketplace.

We have closely followed the work of Subcommittee Chairman Lazio and Representative Fazio, and we wish to applaud their success in reporting H.R. 219 from the Housing Subcommittee earlier this year. We also wish to express our gratitude to Mr. McCollum,

864 Station Street Herndon VA 20170 ■ Phone: 703-736-0994 ■ Fax: 703-736-0953

Mr. Frank, Mr. Maloney, Mr. Baker, and other interested Members of the Banking Committee for their support and to Chairman Leach for scheduling today's hearing.

This morning, I have been asked to comment on the role of private capital and reinsurance markets in addressing the homeowners insurance problems plaguing many parts of the country. We certainly believe there is a role for these markets. However, we do not believe they are the only answer, or even the best solution in many circumstances. They are not the best solution if the goal is to assure that all Americans have access to insurance coverage. They are not the best solution if we want that protection to be adequate and fairly priced and they are not the best solution if we expect to be fully prepared for the large-scale disasters that will occur in the years ahead.

We wish this were not the case. We wish the private market had sufficient financial capacity, as well as all the answers. But common sense, as well as the laws of economics, indicate otherwise -- and we will provide convincing evidence to support that contention this morning.

Large natural disasters are a matter that cannot be handled efficiently without the stabilizing influences of a federal government. The U.S. Army is not listed on the New York Stock Exchange for a good reason. We did not get to the moon thanks to junk bonds. There are certain things for which government must take responsibility, because it can do certain things that no other entity can -- or do them more efficiently in order to benefit the public interest. Helping society cope with large, infrequent natural disasters is one such role. We are not saying that private financial markets and reinsurers cannot play a role. But there is a difference between identifying an appropriate niche for these sources of capital and proclaiming them a savior to the problems of growing insurance availability problems in disaster-prone regions.

Two of HIFA's members, Allstate and Safeco, buy more private reinsurance than any other homeowners insurance company in the Nation. Another member, Farmers

Insurance, is a key participant in the California Earthquake Authority -- the single largest buyer of private reinsurance in the world. Our members are besieged with offers from investment bankers and reinsurance brokers on a frequent basis. Some of these deals make sense. Most do not. If more deals worked, we would jump at the opportunities. Why most capital market products do not work is what we would like to try and explain today.

It is no accident that after six years of trying, the Chicago Board of Trade still has no major transactions to its credit. There is a reason the Catastrophe Risk Exchange, an enterprise started two years ago by a former deputy insurance commissioner in New York has 300 sellers but only two buyers. There is a rational explanation for why the number of catastrophe bonds sold to insurance companies in the U.S. can still be counted on one hand, even though the marketplace is clamoring for solutions.

The answer is that these solutions make only marginal economic sense. If they made more sense, more people would be buying them, just as people are buying nearly everything else Wall Street is offering these days. Few are buying because the transactions are not cost-effective, and they will continue <u>not</u> to be cost effective because high-cost, infrequent natural disasters cannot be efficiently priced in the private market.

This is not an indictment of capitalism. It is simply the truth. And it is not to say that at lower levels, reinsurance is not a cost-effective transaction. After all, reinsurance has been around for centuries. You can reinsure an office complex, or the exposures of insurance companies with a few hundred million dollars of risk. But it is an entirely different matter when we are talking about reinsuring against an event that could destroy St. Louis, or New Orleans -- events that occur less than once every 100 years but have devastating consequences. When large amounts of risk are at stake and the frequency of loss is uncertain, the pricing dynamics of reinsurance and similar capital instruments rise proportionally. Investors are only willing to invest if the return on their money is comparable to what they could earn elsewhere.

The only problem is that homeowners insurance is not sold to the public according to the same rules. Homeowners insurance is regulated. It is priced on the basis of risk, not the desired rate of return in capital markets. What chance is there that a homeowner will have a claim, and how large, on average, is that claim likely to be? These are the relevant questions in the homeowners insurance market. For example, if there is a 1% risk of a certain-sized loss, the homeowner is charged 1% of that potential loss each year. The same principles apply to every kind of insurance. It is what insurance regulators allow, consumers expect and elected officials -- whether they are Members of Congress, a state legislator or a Governor -- demand.

Financial markets and insurance markets do not operate on the same playing field and when it comes to addressing large catastrophes that occur infrequently, these differences are particularly pronounced.

If capital markets are going to reinsure a $25 billion catastrophe, investors quite rightly expect a rate of return at least as good as they could earn elsewhere. But such a return is many times what insurance companies are permitted to charge homeowners and far more than the underlying risk that a claim will occur.

To illustrate, consider the California Earthquake Authority. The CEA buys $2.5 billion worth of reinsurance, more than any other enterprise in the world. Yet even with this coverage, the CEA still cannot pay claims from earthquakes greater than $7.5 billion. A homeowner who buys an earthquake insurance policy from the CEA has no recourse once claims exceed $7.5 billion. Again, that is true even though the CEA buys more reinsurance than any other entity. Why does the CEA not buy more reinsurance protection, when the need is so obvious? The answer is that the CEA cannot afford it, as the chart below makes painfully obvious.

California Earthquake Authority

Total claims-paying capacity	**$7,500 m**
Annual revenues from homeowners premiums	**700 m**
Reinsurance purchased	**$2,500 m**
Reinsurance premiums per year	**320 m**
Losses not covered by reinsurance	**2/3 plus all events greater than $7.5 billion**

The CEA collects $700 million a year from California consumers -- four times what consumers paid just three years ago. A family of four, living in a $250,000 home, will pay $1,000 or more for earthquake coverage, which is in addition to standard homeowners insurance protection. They will have a deductible of 15%, which means the first $38,000 of their losses are not protected. Even so, of the money collected by the CEA, nearly half is used to buy reinsurance which covers less than a third of the CEA's exposure. Looking closer, the situation comes into even sharper focus.

California Earthquake Authority

Analysis of Reinsurance

- **from reinsurance markets**

Reinsurance Layer:	**$1.433 m**
Annual Premium:	**205 m**
Rate of Return:	**14.4%**
Risk of Claim:	**5%**

- **from Warren Buffett**

Reinsurance Layer:	**$1.075 m**
Annual Premium:	**115 m**
Rate of Return:	**10.8%**
Risk of Claim:	**1.0%**

Warren Buffett is one of the investors who sells the CEA reinsurance protection. Mr. Buffett sells approximately $1 billion of reinsurance at a price of $115 million dollars per year, even though the likelihood he will have to pay a claim to California is only 1 percent. From Warren Buffett's perspective, the deal makes perfect sense. He has $1 billion at risk. He makes 11% on his investment and is free to use his money for other purposes until it is needed.

But look at the same deal from the perspective of the CEA. Warren Buffett is assuming a risk that according to actuarial tables should only be $10 million a year, yet he is making $115 million a year on the transaction -- a figure which is ten times the risk! No one has ever accused Warren Buffett of being financially unsophisticated. He sells reinsurance because he can make great returns without assuming a lot of risk. No wonder the insurance company he owns, GEICO, withdrew from the homeowners insurance business three years ago. Why make one dollar in the homeowners insurance market when you can make ten dollars selling reinsurance?

Depending on your point of view, you could argue that homeowners do not pay enough for their insurance coverage. According to such logic, if Warren Buffett demands ten times the risk to reinsure catastrophic exposures, that is what we should pay him.
On the other hand, you could just as easily say that Warren Buffett and the financial markets he represents are ... well, let's just be polite and say they are overly aggressive.

But there is also a third point of view. If homeowners are paying the appropriate amount according to the underlying risk, and if capital market investors like Warren Buffett are simply seeking a fair return on their money, is it really the case that either side is at fault or greedy? Could it be that private capital markets are simply not well suited for solving this particular problem?

Do we want a 10-fold increase in homeowners insurance rates in order to accommodate the needs of the financial markets, even though such rates greatly exaggerate the risks? Is

that serving the public interest? Will a $5,000 homeowners insurance policy encourage consumers to insure their property or will it force people to do without -- raising the stakes for taxpayers and financial institutions if a large disaster does strike?

According to a survey conducted by the Independent Insurance Agents of America last year, 80% of agents in hurricane-prone areas reported that homeowners insurance markets have deteriorated dramatically in the last five years. The most often cited reason for the market decline according to 89% of the respondents was the lack of affordable reinsurance.

Herbert Hoover would have advised to leave the markets alone. But it is neither anti-market, anti-business or anti-American to suggest that there is a national interest in assuring that homeowners insurance markets do not stumble.

Insurance companies are perfectly able to handle most catastrophes. State programs can address the majority of problems that remain and there is plenty of room for financial markets to participate in both these sectors. But H.R. 219 acknowledges that there is 1% of the problem -- events that occur once a century in any given state, that are not efficiently handled in the usual way. It is this one-percent problem that threatens the remaining 99% of the market which would otherwise operate properly. Do we simply stand by and watch the homeowners insurance safety net crumble? Or does the federal government, which does not have to pay investors a 10% rate of return, step forward and offer protection at an actuarially-fair price for the few events that the private market cannot efficiently handle.

Since President Clinton took office, there are have been more than 225 federal disaster declarations. In 1997 alone, there were 43 events, a disaster for nearly every week of the year. None of these events would have triggered federal reinsurance under H.R. 219. But is it so far fetched to think that there are events in the future that will stress our system to the breaking point? Had Hurricane Andrew shifted course one-half of one

degree, it is doubtful that some of the largest insurance companies in the Nation would have survived. Within the last 100 years, Tokyo, Japan was completely destroyed by an earthquake. San Francisco was destroyed by the fire that followed the earthquake. Are we so smug as to think this cannot happen again?

And if it does, what will Members of Congress and the Administration say? That homeowners, state governments and insurance companies should fend for themselves? That taxpayers should go deeper into debt because we did not plan, we did not anticipate and we did not pre-fund for the inevitable?

H.R. 219 is a workable, common-sense solution. It charges risk-based premiums for the one-percent of risks that the private market cannot efficiently handle. It does so without subsidies. It allows states to solve their own problems to the extent they are able, and ultimately preserves the private market which is in everyone's interest to preserve. We urge the Banking Committee to give H.R. 219 the attention it deserves and to report the legislation to the full House as expeditiously as possible -- the sooner the better. Hurricane season begins June 1st. The timing could not be more appropriate.

Thank you.

STATEMENT OF THE

NATIONAL ASSOCIATION

OF

HOME BUILDERS

before the

HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING AND

FINANCIAL SERVICES

on

"THE HOMEOWNERS' INSURANCE

AVAILABILITY ACT"

April 23, 1998

My name is Pierre ("Pete") Lanaux and I am President of Lanaux Construction. I am a builder from New Orleans, Louisiana and appear on behalf of myself and the 190,000 member firms of the National Association of Home Builders. Mr. Chairman, I am pleased to have been invited to appear before you and members of the House of Representatives Committee on Banking and Financial Services to comment on "The Homeowners' Insurance Availability Act".

Mr. Chairman and members of the Banking Committee, you have requested our comments on the Housing Subcommittee's print of H.R. 219. H.R. 219 was marked up earlier this year and represents a combination of the elements of H.R. 219, as introduced, and H.R. 230, the "Natural Disaster Protection and Insurance Act". The Subcommittee print would create a federal backstop through reinsurance to eligible state insurance programs in the event of a major catastrophic event. The legislation is designed to foster accessible and affordable homeowners insurance.

H.R. 219 addresses the problems associated with the unprecedented number and magnitude of natural disasters the United States has suffered since 1989. These natural disasters have raised many policy issues revolving around their impact on the federal budget and who should bear the societal costs. Following the devastation in Florida, Louisiana and Hawaii, caused by Hurricanes Andrew and Iniki, insurance companies paid out over $20 billion in claims in Florida and $2 billion in Hawaii. Between the years 1988 and 1994, the federal government paid over $45 billion in disaster assistance relief.

As a result of this destruction, many insurance companies have either discontinued doing business in these "disaster prone" areas or drastically cut back on the policies they insure, causing dislocations with severe consequences for homeowners and prospective home buyers. States have responded by instituting some form of insurance program or catastrophic fund. Because part of the destruction caused by Hurricane Andrew was attributed to the lack of effective building code enforcement as well as specific code compliance problems, many in Congress and elsewhere have linked insurance coverage to certain building code compliance mandates. NAHB has opposed and will continue to oppose any legislation containing onerous provisions which mandate codes and standards at the federal level without any consideration of the cost or affordability to homeowners and renters.

The National Association of Home Builders (NAHB) is pleased that H.R. 219, as currently crafted, contains no federal mandate relating to state and local building code compliance and adoption provisions for "disaster prone" areas. At the same time, H.R. 219 begins to address the very real needs associated with the availability and affordability of homeowners insurance for coverage of certain perils. For this reason, NAHB can support the overall objectives of H.R. 219 and the process for moving the bill forward.

While there are certain aspects of H.R. 219 on which NAHB has taken no formal position, my testimony is, therefore, necessarily confined to those provisions relating to state hazard mitigation plans. These provisions would also have a direct impact on housing affordability and our livelihoods. As noted above, H.R. 219 is silent on mandatory federal code requirements. H.R. 219 addresses mitigation by requiring each eligible state insurance program to devote at least 10% of its net investment income from the state program to measures to mitigate losses from natural disasters in that state. This requirement is conditioned upon the allocation not interfering with the actuarial soundness of the fund. This requirement is consistent with most state programs established to date.

H.R. 219 would leave to the discretion of the pertinent states what type of mitigation programs they should adopt. NAHB agrees that the establishment of state programs without federal intrusion is the preferable approach. Traditionally, the health and safety of the general populace has been the prerogative of the states. This longstanding principle is well founded as it is important to remember that each state/region is subject to differing perils as well as varying degrees of risk. What might be an effective or necessary mitigation strategy in Florida may not be an appropriate or effective strategy in Louisiana or Texas.

With respect to the development of state mitigation programs, NAHB argues that mitigation programs should not be focused exclusively on new construction, but that strategies should address existing structures which comprise the vast bulk of the housing stock. Such programs could include emergency preparedness/response programs, design and construction education programs, voluntary programs with insurance premium reduction incentives, enhanced code official certification requirements, or a whole host of strategies. However, these programs should be left to the states to develop to address the particular nuances of their localities.

In my own state of Louisiana, for example, property damage from hurricanes and the consequent flooding is one primary source of concern. The cost of homeowners insurance has dramatically increased since 1992. Louisiana has responded to this problem by establishing a disaster insurance program funded by voluntary participants, who are either commercial enterprises or homeowners. The funds are only available, however, for high wind areas near the Gulf Coast. To my knowledge, there is no special mitigation program other than the enforcement of existing building codes. Also, it bears mentioning, that much of Louisiana is at or below sea level so that builders must already comply with FEMA's elevation requirements.

Finally, I would like to add our support for a proposed change to H.R. 219. The National Association of Realtors, like the NAHB, is concerned that homeowners insurance be accessible/affordable. We agree that the legislation should require a study evaluating the availability and affordability of insurance and the extent to which state and private insurers are addressing the problem. Such a study was part of H.R. 230 and we hope that a similar provision could be incorporated into H.R. 219. Also, to the extent that the National Commission on Catastrophe Risks and Insurance Loss Costs, created by H.R.219, can be reconfigured to include representatives of consumer and real estate groups, it should be.

Again, I thank you for the opportunity to present the views of the housing industry on this very important issue. We stand ready to assist you in any way possible to ensure that housing consumers are not adversely impacted by this persistent problem.

STATEMENT OF BABETTE HEIMBUCH
FIRST FEDERAL BANK OF CALIFORNIA
OF BEHALF OF THE WESTERN LEAGUE OF SAVINGS INSTITUTIONS
APRIL 23, 1998

Mr. Chairman and members of the Committee. My name is Babette Heimbuch and I am President and Chief Executive Officer of First Federal Bank of California, headquartered in Santa Monica, California. My institution has 24 branches and holds in excess of $4 billion of assets. I am also a member of the Board of Directors of the Western League of Savings Institutions, on whose behalf I appear today. The Western League represents the thrift associations of California, Arizona and Nevada.

I would first like to thank Chairman Leach for scheduling this hearing and giving this important policy issue a thorough public airing. I would also like to thank Subcommittee Chairman Lazio and Representatives Fazio, McCollum and Campbell for their leadership on this bill. Finally, we appreciate the constructive input the Administration is providing, especially the positive suggestions of Secretary Summers this morning. I very much value the opportunity to participate in this hearing on an issue which is a great concern to the lenders of California.

You may be wondering why an executive from a California savings and loan would want to come all the way to Washington to testify on legislation dealing with disaster insurance. The answer is quite simple. Depository institutions, whether they are located in seismically-prone regions like California, Missouri or Tennessee, or hurricane areas such as Florida, the Carolinas or New York face the potential of crippling losses should the traditional safety net of private homeowners insurance fail. Mr. Chairman, I am here to tell you that the system is indeed failing.

Over the last decade in California, we have experienced earthquake disasters that have caused many billions of dollars of losses. These events caused a severe deterioration in the availability of earthquake insurance coverage. So bad, in fact, that in 1995, the California Department of Insurance reported that 95% of the insurance companies in the state would not underwrite new homeowners insurance coverage.

As you might imagine, the consequences of the insurance market failure were quite alarming to financial institutions in California. As of the third quarter of 1997, there are 62 federally and state-chartered savings institutions in California which together hold some $195 billion of real estate loans, of which $185 billion are residential loans. FDIC-insured financial institutions in California -- banks, savings institutions and thrift and loan companies -- together hold nearly $330 billion in real estate loans.

To illustrate the magnitude of a failed insurance market, let us suppose the consequences of a major earthquake which causes $50 billion in losses. Such losses could translate into potential losses to homeowners, banks and thrifts of billions of dollars of property if homes were abandoned by their owners for lack of funds for repairs. And these problems would be exacerbated in a real estate market where home values and owner equity is declining.

Depository institutions would not be the only casualties. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation would also be at risk. Major losses would also be incurred by the Federal Housing Administration and the Veterans' Administration. Finally, the federal deposit insurance funds could be placed at great risk. Indeed, it is not an exaggeration to say that the greatest risk to the funds protecting America's financial institutions is not a financial collapse but a large-scale natural disaster. If a major earthquake and a major hurricane were to occur in the same year, the total gross real estate losses for depository institutions could force many lenders across the nation into insolvency. A California event alone could have huge consequences. As of the third quarter of 1997, more than 35% of the assets of OTS-regulated thrifts were held by California institutions.

I would like to illustrate some of the problems I have alluded to by describing the experience of my own institution, First Federal Bank of California. My bank suffered losses in excess of $16 million from the Northridge earthquake of 1994. That represents 8% of the Bank's net worth. The bulk of those losses were from loans on apartment housing for low-income families. The majority of losses from single

family loans were condominiums. The coverage now being offered by the California Earthquake Authority would not have protected the bank against these losses.

California has tried to solve the problem on its own, but quite frankly, the solutions in place that have already been described by others this morning are simply not enough. The California Earthquake Authority has indeed alleviated the problem of homeowners being unable to find earthquake insurance at any price. But the CEA provides less coverage, at a higher cost, than what was available before the Northridge earthquake. Deductibles are higher and the program does not cover multi-family structures. And even more alarming, the fund cannot cover losses from an earthquake that causes more than $7.5 billion in losses. But these problems are not of the CEA's making. The stark reality is that no state has the means of creating a program capable of handling the true mega-catastrophe. The CEA buys more private reinsurance than any other entity in the world. Yet that coverage is only $2.5 billion -- a small fraction of the California exposure. Even this small amount of reinsurance costs the state almost 50 cents out of every premium dollar collected from homeowners -- a premium I might add that has increased nearly four-fold in the last three years. Clearly, the CEA does not provide adequate protection. But it is all we have at the moment. Federal reinsurance would provide California with important flexibility that can result in improvements to the CEA and better coverage for consumers.

We recognize that some have criticized H.R. 219 for its reliance on state-operated government entities rather than the private sector. We are not experts on the pros and cons of various funding mechanisms, but we do believe that is a role for both state and federal government. Only government can design and compel responsive insurance programs that provide adequate affordable natural disaster insurance. Even a program based on state plans leaves broad segments of the market for the private sector and H.R. 219 provides for federal reinsurance only if 100-year loss experiences are exceeded.

We urge you, based on our experience, to focus on these general principles as you proceed to mark-up the bill:

- ***Legislation should reflect good public policy.*** The development of a national disaster program should be rooted in the principle that those who live in areas at risk provide protection for themselves rather than relying on the eventuality of federal disaster relief.
- ***A federal solution is needed.*** An effective and comprehensive response to the risks posed by natural disasters is beyond the ability of any state and too costly if left to the private sector alone.
- ***Insurance must be widely available at reasonable rates.*** This again would argue for federal involvement. A viable natural disaster insurance program requires the widest possible pool of participants. *Ideally*, the requirement to purchase natural disaster insurance should be made mandatory much as the requirement for fire insurance is. Participation could also be increased by making federal disaster assistance available only to those who have purchased disaster insurance. These may be highly controversial suggestions, but they still ought to at least be discussed.
- ***Adequate incentives to mitigate risks should be provided.***
- ***The program must include multi-family as well as single-family residences.*** This provision is already included in H.R. 219 and I urge you to make certain it remains in the bill.

We thank you again for the opportunity to participate in this hearing and look forward to assisting in whatever way we can in creating a viable, effective nationwide program to address the risks of natural disasters.

The Potential Role of Government in Financing Catastrophic Risk
April 23, 1998

Testimony before the House Committee on Banking and Financial Services
U.S. House of Representatives

Christopher M. Lewis
Policy Economics, Risk Management and Regulatory Practice
Ernst & Young LLP Economics

Chairman Leach and Members of the Committee:

Thank you for the opportunity to appear before you today to discuss the important topic of whether and how the Federal Government could improve our nation's ability to finance the losses created by large natural disasters. As many of the other panelist have asserted, a strong economic and financial case for federal involvement in improving the allocation of disaster risk in the United States can be made, especially in the areas of pre-disaster mitigation and the financing of large insured losses from catastrophic events. However, the need for federal involvement is also limited in scope and requires a very carefully designed program that does not interfere or distort the existing private insurance market or regulatory structure.

To assist in this effort, I appear before you today on my own accord – not representing Ernst & Young LLP,any client or interest group—to give you the benefit of my experience in studying this issue over the past several years both as a member of the White House Working Group on Natural Disasters and as a private risk management consultant in the insurance industry. Furthermore, while cost-effective mitigation would be an important component of any federal disaster policy agenda, my expertise resides more in the financing of catastrophic risk. Hence, the majority of my comments will focus on the financial aspects of the current catastrophic risk problem facing the nation today.

What is the Nature of the Problem?

Over the past 10 years, the United States has witnessed a significant rise in the magnitude of insurance industry losses from natural disasters. In nominal dollars, nine out of the 10 largest U.S. catastrophes in history have occurred since 1989. In fact, after adjusting for housing price inflation, insured losses over the 1989-1995 period totaled almost $75 billion, more than five times the average real insured losses during the prior four decades. More importantly, however, is the fact that one of the major factors driving this increase in disaster losses is the continued development in high-risk areas of the country.

To illustrate this fact, Table 1 examines the potential magnitude of prior disaster events if they were to occur today given today's build-up in property values in high-risk areas of the country. Specifically, Table 1 adjusts the losses associated with all disaster events

experienced over the 1949-1997 period for the migration of U.S. population into higher risk regions of the country and the resulting increase in the value of housing stock in these areas. After making these adjustments, Table 1 ranked the 10 worst disasters in terms of $1994 losses.

Not surprisingly, three of the top 5 disaster losses were Hurricane Andrew ($18 billion), the Northridge Earthquake ($12 billion) and Hurricane Hugo ($6 billion). More surprisingly, however, is that six out of the 10 largest disasters in history actually occurred during the twenty-year period from 1950-1970. That is, if the same disaster events that occurred in the period 1950-1970 were to reoccur today with the current concentrations in population and housing values in these regions, industry losses from these events would total almost $34 billion.

Table 1: The 10 Largest Catastrophes in U.S.: 1950-1996
Adjusted for Regional Residential House Price Inflation (1)
($1994 Billions)

Event	Date	Loss
Hurricane Andrew	8/24/92	18.4
Northridge Earthquake	1/17/94	12.5
Northeast Winter Storm	11/24/50	11.8
Hurricane Carol	8/30/54	6.8
Hurricane Hugo	9/17/89	6.3
Hurricane Hazel	10/15/54	5.2
Hurricane Betsy	9/7/65	4.6
Hurricane Cecilia	8/3/70	3.0
Hurricane Donna	9/9/60	2.5
California Fires	10/20/91	2.3

(1) Based on Property Claims Services data adjusted for the change in the value of urban and rural owner-occupied buildings in each state using the U.S. Census of Housing Series HC80-1-A.
(2) See Cummins, J. David, Christopher M. Lewis, and Richard Phillips, "Pricing Excess-of-Loss Reinsurance Contracts Against Catastrophic Loss," in ed. Kenneth Froot, The Financing of Property Casualty Risks. National Bureau of Economic Research, in press.

More troubling is that this trend in growing exposures is continuing. Insured coastal property values in the United States grew 69 percent from 1988 to 1993 to $3.15 trillion. Similarly, the average annual growth rates in the population per square foot in California (2 percent) and Florida (3.2 percent) over the past fifteen years have been double and triple the average national growth rate for the whole U.S. (U.S. Bureau of

the Census, 1994)[1]. Furthermore, research on frequency and magnitude of hurricanes and earthquakes measured by the Saffir-Simpson and Richter scales, respectively, indicates a strong potential for disaster activity to remain at or above cyclically high levels over the next 20 years – strong indications that disaster losses will continue to be a real problem facing this country.

This increased recognition of disaster exposure has sent reverberations throughout the private sector financial markets. Reinsurance companies responded to this increased exposure quickly by raising rates. Discussions with insurance company executives indicate that reinsurance rates increased by as much as 150 percent from 1993 to 1995. With a rise in reinsurance rates, an increased catastrophe exposure retention, and a realization of their overexposure to disaster risk, primary insurers sought comparable rate increases. When these rate increase proposals were pared down in the process of state insurance rate approval, insurers started to withdraw from the market, causing a drop in the availability of insurance coverage for individuals living in high risk areas of the country. In response, states instituted new regulations restricting insurer exits, established new state insurance facilities and approved modest increases in primary insurance rates. The net result, however, was a continued overexposure of insurance companies to natural disaster risk. Similar disruptions occurred after the Northridge earthquake.

The concern over natural disaster expenditures after Hurricane Andrew was not limited to the insurance industry. In a 1994 Senate Task Force Report, the U.S. Congress raised concerns over the growth in long-term disaster recovery expenses incurred by the federal government. Thus, at the same time the insurance industry started seeking federal assistance in reducing their catastrophe exposure, the federal government was concerned with the budgetary implications of disaster recovery expenses that already were being incurred.

How Catastrophic Losses are Financed Today

Ultimately, the losses from natural disasters always are paid by only one constituency – the American people. However, the method through which the costs of natural disasters accrue to the American people (e.g., taxes vs. policy premiums vs. direct losses) is critical in optimizing the overall welfare of society. For example, if all losses were financed through federal post-disaster assistance, which in turn is financed by general tax revenues, the general tax code would determine who bore the costs associated with disaster losses. In this case, the burden of financing disaster risk would not be linked to the individuals creating the disaster exposures and individuals would continue to increase society's overall disaster exposure by building in high-risk areas – clearly an undesirable solution.

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[1] Lewis, Christopher and Kevin Murdock, "Alternative Means of Redistributing Catastrophic Risk in a National Risk Management System," in ed. Kenneth Froot, The Financing of Property Casualty Risks, National Bureau of Economic Research, (In Press).

Alternatively, if all disaster losses were completely financed up front through the purchase of insurance contracts at an actuarially-fair premium, individuals would have to factor the costs of insurance into their decisions on where to locate and how much disaster mitigation to incorporate into their building decisions. As a result, individuals would have an incentive to build in lower risk areas of the country, reducing the growth in the country's overall disaster risk and optimizing the allocation of risk in the economy. Self-insurance accomplishes the same goal of risk internalization, but without the benefits of diversification offered by insurance.

Ideally, a comprehensive system for financing catastrophic losses would (1) create strong incentives for individuals to mitigate or reduce their exposure to loss from disaster events (and thereby, the overall exposure of society); (2) improve the efficiency and effectiveness of how losses that do occur are financed; and (3) provide for quick response in assisting individuals that do need assistance in the wake of a disaster. The question before the Committee is how can Federal policy help foster a market-based solution that meets these objectives? To address this question, however, requires a closer examination of the problems in the insurance markets that are preventing a market-based solution today.

The Role of Insurance

In financing property/casualty disaster risk, insurance companies are the primary intermediary in the U.S. economy. Individuals living in disaster-prone areas are exposed to considerable losses from disaster events. In providing disaster insurance, an insurance company offers to assume a portion (e.g., over a deductible) of the policyholder's disaster risk exposure in exchange for a premium. After accumulating these policyholder positions, the insurance company can diversify its disaster risks through risk pooling (aggregation), risk identification and segregation, risk monitoring, and risk mitigation. That is, insurance companies serve a valuable role in identifying, monitoring, pricing, and controlling the individual risks associated with property coverage: risks that are too asymmetrically under the control of the insured to be effectively traded directly in the capital markets where more public information on risk is required.

An insurance company's ability to diversify insurance risks through pooling is extremely effective when risks are independent and identically-distributed like fire insurance. However, in the case of large idiosyncratic risks like disaster risk, where multiple policies are effected by the same event, the benefits of pooling are significantly less. For these events, diversification must occur across time with insurers financing disaster exposure through the purchase of reinsurance, the issuance of capital market securities or through stockholder equity. For most disaster risks, the problem does not reside in whether the events are "insurable," but whether the insurance company can establish an effective mechanism for accomplishing this intertemporal smoothing of claims.

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Historically, insurance companies have relied largely on reinsurance or self-insurance to smooth claims over time. Reinsurance provides a useful source of capital for regional and local insurance firms and plays an integral role in expanding capacity in the primary insurance market. The primary advantage of reinsurance is to achieve a greater degree of spatial diversification through pooling and better price disclosure, although reinsurance also can assist in the intertemporal diversification of disaster losses through the maintenance of long-term (implicit contract) relationships. However, given their own limited liability and exposure constraints, even large reinsurers lack adequate capacity for intertemporally diversifying large disaster losses. Limited liability, regulatory pressure and a competitive market place similar constraints on an insurance company's ability to accumulate large capital reserves against disaster risk. In addition, even if an insurer could accumulate adequate reserves over time, if a disaster occurs before the reserve is adequately funded, the insurer risks bankruptcy.

In response, considerable attention has been focused on creating alternative market mechanisms for insurance companies to hedge their exposure to natural disaster risk. As a result, in the early 1990s, insurers started looking for alternative forms of inexpensive capital. The natural place to look was the $19 trillion capital markets.

Capital Market for Catastrophe Securities

The prospect of finding another source of capital through disaster derivatives or securitization was alluring to insurance and reinsurance firms because of the sheer size of the capital market. If financed through the capital markets, natural disaster losses of the magnitudes of the Northridge earthquake and Hurricane Andrew would be swamped in the normal trading volatility in the securities markets. Furthermore, in the market of rising reinsurance rates following Hurricane Andrew, insurers saw the capital markets as a possible source of cheaper funding.

Catastrophe securities also were seen as offering advantages to institutional investors. On the investor side, the attraction of securities in disaster risk is the ability to better diversify their investment portfolio by adding a new security with a return that is largely uncorrelated with the returns associated with stock and bond portfolios. Furthermore, an examination of the reinsurance market suggests that the potential investor return from catastrophe securities could be significant. Thus, catastrophe securities can be structured to yield an attractive risk-adjusted rate of return for investors.

Recognizing these advantages, insurers and investment banks have made considerable investments in developing new capital market products that are attractive to both insurers and investors. These products include such instruments as:

- **Cat Bonds**: Cat Bonds are debt instruments that carry above market interest rates, but where the interest or principal payments on the bonds vary based on the loss experience of an underlying index. The underlying index has been based on either the insurer's own loss experience (indemnity bond), an industry index of loss experience (index bond), or on some combination of both (e.g., double trigger). In a typical Cat Bond transaction, a Special Purpose Reinsurance company (SPR) is established off-shore to provide direct reinsurance to an insurer. The SPR is then financed through the issuance of the Cat Bond securities.
- **CatEPuts**: Catastrophe Equity Put options (CatEPuts) are contingent equity arrangements that give the holder (i.e., the insurance company) the option to call on additional capital investment from the option writer (i.e., reinsurer or investor) following a catastrophic loss. Essentially, a CatEPut allows an insurer to shore-up its balance sheet after a catastrophic loss.
- **Contingent Surplus Notes (CSN)**: Under a CSN arrangement, investors make a principal investment in an insurance company trust collateralized with Treasury securities that pays an above market interest rate. In return, the insurer retains the option to replace the Treasury collateral with company surplus notes in the event of a (catastrophic) event.
- **Chicago Board of Trade PCS Options**: The CBOT created the first catastrophe derivatives market back in 1992 with the advent of catastrophe futures and options. Currently, the CBOT offers options benchmarked to the PCS (Property Claims Service) index of insured catastrophe losses in nine US regions. The PCS cat insurance options offer a risk transferring option for insurers and are typically sold as call spread options, which are similar to traditional excess-of-loss reinsurance contracts. Buyers simultaneously buy and sell call options with different strike values to create a desired coverage layer.
- **CATEX:** Starting October 1996, the Catastrophe Risk Exchange (CATEX) was established in New York and, more recently Bermuda (CATEX Offshore), as a swap market for insurance risk trying to further diversify geographically.
- **BCE Options**: The Bermuda Commodities Exchange (BCE) which opened in November, 1997 offers an option similar to the CBOT PCS option and is based on the Guy Carpenter Index of industry losses. The BCE options are for windstorm damage to homeowners policies only, but are available at the zip code level.

Following several years of lackluster performance, the catastrophe securities market registered significant progress as a new asset class for securitization in 1997. During the year, the market registered over $1 billion in new issuances, including transactions by USAA, Swiss Re, Winterthur and Tokio Marine. In fact, several of these transactions were oversubscribed – demonstrating a latent demand by investors for these new instruments. All indications suggest that 1998 will exceed the $1 billion mark set in 1997; and if the catastrophe market continues to follow the evolutionary path of other asset-backed securities markets, new issuance could grow significantly over the next five years.

Notwithstanding this potential, the securities market faces many obstacles that need to be overcome before a fully developed market can be established. For example, the market faces a lack of standardization in risk measurement and in structuring transactions, a lack of a generally-accepted index on which to base payouts, and high transactions costs vis-a-vis traditional sources of reinsurance. Thus, even if the private capital market is able to grow over the next several years, catastrophe securities will be more likely to provide additional capacity for insurers in the low to medium range of disaster losses. That is, capital market solutions are unlikely to provide the answer for financing truly catastrophic events (e.g., disaster events resulting in over $30 billion in industry losses) for quite some time, if at all.

The Need for a Federal Government Role

Given the shortcomings within the existing markets for financing disaster claims over time, insurance companies, reinsurers, states, and other constituents have raised the issue of a Federal role in the financing of disaster insurance. Historically, the insurance industry, which is regulated by state governments, has opposed federal intervention in the insurance marketplace. However, the large scale disruptions created by Hurricane Andrew and the Northridge earthquake in recent years have prompted many members of the insurance industry to call for some type of federal assistance for catastrophe claims given the magnitude of insurer disaster exposures and the lack of a mechanism to smooth large disaster claims overtime.

To their credit, some states have worked to develop short-term solutions. For example, in 1996, California started the California Earthquake Authority(CEA). The CEA began operations with participating companies contributing the initial $700 million in capitalization. Similarly, the state of Florida has created the Florida Hurricane Catastrophe Fund – a mandatory catastrophe reinsurance pool for property insurers writing business in Florida. The CEA and the Florida Catastrophe Fund clearly have the capability to finance a small or moderate disaster. However, states even the size of California and Florida do not have the financial capacity for financing major disasters, even given their substantial tax advantage over private insurance companies. Furthermore, existing state programs have raised concerns within the insurance industry over residual insurer liabilities to state funds and the creation of "thinly capitalized" insurance affiliates within the state. As a result, there is a growing recognition that these states funds are only a partial solution.

Market-enhancing Federal Policy

Evaluating the potential role of the Federal Government in the financing of catastrophic risk is an important issue. In examining the current problems facing the insurance industry and in the financing of catastrophic risk more broadly, two shortcomings in the current allocation of catastrophic risk become apparent – the lack of internalization of risk in individual decision-making and the absence of a mechanism that would allow the insurance industry to smooth large disaster claims over time. In addition to cost-effective

mitigation, the encouragement of actuarially-priced insurance is one mechanism for improving the internalization of risk at the individual level. However, encouraging the use of insurance will be ineffectual unless insurance companies can provide the insurance policies without jeopardizing their solvency. Thus, insurers also would need a solution that enhances their ability to finance disaster claims over time, thereby expanding their capacity to provide insurance protection at a given insurance premium.

To develop a federal program that can expand the capacity of the insurance industry without interfering in the regulatory framework of the insurance industry and while continuing to support innovation and development in the insurance and capital markets presents a considerable challenge. Equally as difficult will be developing an approach that is narrowly-defined and targeted at providing a mechanism for intertemporal risk diversification without encouraging additional risk-shifting to the Treasury or to other insurers. In this respect, the Federal Government's unique position in the debt markets is a great advantage. However, the difficulty is designing a program sufficiently targeted to only utilize this unique borrowing authority. Other issues that such a program would face include the following:

- Avoiding any replacement of displacement in the insurance industry, including favoring one segment of the industry (e.g., state funds) over other segments of the industry (e.g., direct insurance writers).

- Setting appropriate attachment points and caps on the federal government's overall exposure so as to allow the private sector to continue to provide coverage layers of disaster losses consistent with industry losses of up to $25 or $30 billion.

- Maintaining the current state regulatory framework where the critical link between state regulation of insurance company solvency, insurance rate approval, and the state guaranty fund structure is maintained.

- Fostering the development and innovation of the capital markets, effectively allowing private sector innovation to crowd out the public sector program.

- Pricing the program at "normal" market rates that include such factors as the average expected cost, a charge for measured variance in expected costs, an administrative load, and a cost-of-capital charge consistent with normal reinsurance rates (5-7 percent over Treasury securities) and obtaining full information on changing market perceptions with respect to risk.

- Avoiding the creation of another federal bureaucracy to support any program that is created.

- Creating a program that is budget neutral according to the standard budget practices employed by the Congressional Budget Office and the Office of Management &

Budget. (Of course, according to current budget practice, any program that is priced as described in the previous bullet would exceed the requirements currently imposed on any other program in the budget).

- Avoiding the creation of a direct federal insurance or reinsurance mechanism that is subject to risk-shifting (e.g., moral hazard or adverse selection) by the insured.

Conclusion

In conclusion, there is a strong economic and financial argument for the federal government to play a role in the financing of catastrophic risk. However, the challenge for the Committee is how to correctly define this role so as to encourage cost-effective mitigation and the development of a mechanism that would allow the insurance industry to smooth large disaster claims over time.

At this point, I would be happy to answer questions that the Committee may have on my perspectives on the role of the Federal Government in financing catastrophic risk.

STATEMENT OF

THE NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE

ON H.R. 219, THE HOMEOWNERS' INSURANCE AVAILABILITY ACT

April 23, 1998

INTRODUCTION

Thank you for the opportunity to present the views of the NATIONAL ASSOCIATION OF REALTORS® (NAR) on H.R. 219, the Homeowners' Insurance Availability Act.

My name is Catherine Whatley. I am a REALTOR® from Jacksonville, Florida, and I am the 1998 NAR Regional Vice President for Region V, which is comprised of several Southeastern states as well as the Virgin Islands and Puerto Rico.

The deterioration in the availability and affordability of homeowners' insurance in disaster-prone areas is an issue of very real concern to the NATIONAL ASSOCIATION OF REALTORS®. Our members are involved in all aspects of the real estate industry, but they specialize primarily in the business of assisting sellers and buyers in residential sales transactions. It is this business focus that motivates NAR's primary interest in the resolution of this situation: promoting the availability of affordable homeowners' insurance to homebuyers throughout the nation.

Although I am testifying today on behalf of the real estate industry, I cannot emphasize enough that the ultimate victim of the homeowners' insurance crisis is the consumer who is frustrated in his or her attempt to realize the American Dream of homeownership. And when a young family is precluded from owning a home because homeowners' insurance is too difficult to obtain or too costly to afford, we all suffer the consequences.

IMPACT OF RECENT DISASTERS ON THE INSURANCE INDUSTRY

In the wake of the devastating 1994 Northridge earthquake in California, insurers accounting for over 90 percent of the market stopped selling new homeowners' insurance policies or imposed strict limits on the policies they issued. After paying out $12.5 billion in claims to Northridge victims - more than three times the amount of earthquake premiums they had collected in the 25 years prior to Northridge, insurers feared that they wouldn't have the financial resources to cover damages from another major earthquake. Earthquake insurance rates have roughly doubled, while coverage levels have declined.

The experience in my home state of Florida has been similar. Hurricane Andrew in 1992 caused the insolvency of seven property and casualty insurers, and others were financially impaired. After paying out more than $16 billion in claims after Andrew - more than their total profits of the prior 25 years, insurers began re-evaluating the risks of doing business in Florida. In the five years since Andrew, the five largest property insurers have raised their homeowners' insurance rates an average of 83 percent. Insurance deductibles have also been raised, which spells disaster for a property owner faced with the obligation of covering the deductible out of his or her own pocket if a hurricane strikes.

This problem is by no means limited to Florida and California. Insurers are limiting their homeowners' insurance business in disaster-prone areas of Louisiana, Georgia, North Carolina, South Carolina, New Jersey and New York. In Missouri and other states in the vicinity of the New Madrid Fault, insurers are reducing their exposure to earthquake loss by raising earthquake insurance deductibles and premiums. Considering the number of states that are prone to natural disasters, this is truly an issue of national importance.

CONSEQUENCES FOR THE REAL ESTATE INDUSTRY

The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market. Not only does it imperil the market for single family detached homes, but the condominium, co-op and rental markets are affected as well. New home purchases, resale transactions and housing affordability are negatively impacted in the following ways:

✓ **Homeowners' insurance is a necessary component in securing a mortgage and buying or selling a home**. As prospective home buyers find it increasingly difficult to obtain the homeowners' insurance required by lenders to complete their home purchases, closings are delayed. If a potential homebuyer is ultimately unable to obtain the required insurance, because the insurance is either unavailable or unaffordable, the sale will not be completed. As a result, creditworthy potential homebuyers are priced out of the market. In a recent NAR survey, respondents reported that an estimated 2,450 transactions fell through because of difficulties in obtaining disaster insurance. Seventy-five percent of respondents cited unaffordability as the reason.

✓ **Homeowners' insurance is tied directly to the cost of owning a home**. If a homeowner is unable to maintain insurance required by a mortgage lender, the mortgage is in default. If insurance coverage is optional, as is the case with earthquake insurance in California, potential buyers may choose not to purchase a home simply because the insurance they consider essential is too expensive. Existing homeowners who are of like mind may be unwilling to continue to own their homes without the protection of earthquake insurance. Others may choose to go unprotected.

✓ **Insurance costs impact rent levels**. Insurance costs incurred by landlords are ultimately passed on to tenants. Consequently, increased insurance costs result in higher rents.

NATIONAL ASSOCIATION OF REALTORS® POSITION

The NATIONAL ASSOCIATION OF REALTORS® supports legislation that facilitates a solution to the disaster insurance crisis. We support H.R. 219 for the following reasons:

- ✓ **It protects against mega-catastrophes.** State programs that have been created to address the problem, such as the California Earthquake Authority (CEA) and the Florida Residential Property and Casualty Joint Underwriting Association (JUA), are well-intentioned first steps. They have addressed the situation in the short-term, and homeowners' insurance is currently available in these states. However, neither state disaster programs nor the private insurance industry have the capacity to cover the risk presented by mega-catastrophes. Depending on where the event occurs, it is estimated that a mega-catastrophe costing the industry \$50-\$100 billion or more could result in the insolvency of up to 36 percent of all insurers

  Considering expert predictions of more severe hurricanes and earthquakes in the near future, as well as the increasing population density in high-risk areas such as Florida, California and Texas, the occurrence of such an event is not a matter of *if*, but ***when***. The creation of a federal disaster reinsurance program today will help to prevent future interruptions in the availability of homeowners' insurance.

- ✓ **It promotes fiscal responsibility.** By establishing a program which promotes insurance coverage for those at risk of property losses from a natural disaster, H.R. 219 will minimize future unforeseen disaster assistance expenditures and keep us on course to balance the federal budget. It is time to begin planning for disasters we all know will occur and to put the responsibility for shouldering the cost of disaster preparedness and response on those who are at risk.

As previously stated, NAR's primary concern is the availability of affordable homeowners' insurance. Any federal program that is created must be designed to achieve that goal. To that end, we urge that H.R. 219 be amended to require an agency study evaluating the availability and affordability of insurance and the extent to which states and private insurers have responded to the availability/affordability problem.

CONCLUSION

A strong housing market is a linchpin of a healthy economy. Real estate generates jobs, wages, tax revenues and a demand for goods and services. When the unavailability of affordable homeowners' insurance in disaster-prone areas threatens the real estate market, local and regional economies suffer. In order to maintain a strong economic climate, we must safeguard the vitality of residential real estate.

But more importantly, we must safeguard the cornerstone of the American Dream. The NATIONAL ASSOCIATION OF REALTORS® supports a federal response to the disaster insurance crisis which helps to make the dream of homeownership a reality for more and more Americans. We urge the Banking and Financial Services Committee to take action this year on this very important issue.

Thank you again for the opportunity to present the views of the NATIONAL ASSOCIATION OF REALTORS®. I am happy to answer any questions.

Consumer Federation of America

STATEMENT OF

J. ROBERT HUNTER,
DIRECTOR OF INSURANCE

BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
OF THE
U.S. HOUSE OF REPRESENTATIVES

THE CONSUMER POSITION ON
H. R. 219 –"THE HOMEOWNERS INSURANCE AVAILABILITY ACT OF 1997"

APRIL 23, 1998

1424 16th Street N.W. Suite 604 • Washington, D.C. 20036 • (202) 387-6121

STATEMENT OF J. ROBERT HUNTER,
DIRECTOR OF INSURANCE
CONSUMER FEDERATION OF AMERICA
BEFORE THE COMMITTEE ON BANKING
AND FINANCIAL SERVICES
OF THE U.S. HOUSE OF REPRESENTATIVES
H.R. 219 -- APRIL 23, 1998

My name is Bob Hunter. I am Director of Insurance for Consumer Federation of America (CFA). I served as Federal Insurance Administrator under Presidents Ford and Carter, during which time I administered the National Flood Insurance Program. I also served as Texas Insurance Commissioner during the early 1990s during which time I developed a comprehensive disaster response plan for insurance and, unfortunately, got to see it work in large floods in the Houston area and a devastating tornado near Dallas.

I am speaking today on behalf of both CFA and Consumers Union.[1]

Background

The 1990s have been an era of remarkable natural disaster activity. Of the ten most costly insured events, only one (Hurricane Hugo, 1989) did not occur in this decade.

But, despite the disasters, the insurance industry is not only solvent, it is doing very well indeed. Chart 1 shows two remarkable things:

- Costs of disasters have skyrocketed in recent years so that, in the 5 years ended 1996, the insurance companies paid out over $60 Billion in disaster claims.

- Even with these remarkable payouts for disasters, the surplus of the property/casualty insurance business has skyrocketed over the last seven years, more than doubling in size to $300 billion at year end 1997.

[1] CFA is a nonprofit consumer advocacy organization representing over 250 state, local and national pro-consumer organizations with a combined membership of over 50 million Americans.

Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide consumers with information, education and counsel about good, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 4.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

The insurance consumer has been hard hit by the disasters, however. The reaction of the industry to the disasters has been to sharply cut back coverage and raise premiums. While the worst of that is over as the reinsurance industry has righted itself and prices for reinsurance have dropped in recent years, consumers in disaster prone areas can often only buy disaster insurance at substantially higher prices for considerably less coverage.

As insurers have raised deductibles and otherwise restricted coverage, not only has the consumer risk risen substantially, but the taxpayer has become more exposed. For example, in California, CEA actuaries estimate that the typical policyholder of an earthquake policy through the California Earthquake Authority (CEA) will bear 63% of the costs of the average future earthquake under the limited coverage available there. This will mean that both the consumer and the taxpayer will bear much more of earthquake costs than ever before in California.

The Need for a Coordinated National Public-Private Disaster Policy

Before Congress moves to provide assistance to the insurance industry for disasters, it must assess the relationship between taxpayer-financed disaster relief and protection currently provided by the private market. Any program Congress enacts must help ensure that the capacity to provide coverage by the private market is maximized and that losses to the federal and state taxpayers are reduced through mitigation and private market mechanisms as much as possible.

The relationship of insurance and taxpayer funded relief is an important one. Chart 2 shows that insurance payouts for catastrophes are large for wind type claims (73.9% of cat payouts are for tornado, hurricane and other wind incidents). Only 9.1% of the payouts is for earthquake and nothing is paid out privately on flood claims because that is a federal program.

Correspondingly, the chart on the lower part of Chart 2 shows that disaster relief payments are 35.4% for earthquake, 15.6% for flood and 23.0% for hurricane.

Charts 3 and 4 show the effects of private versus tax-financed coverage. Chart 3 shows that people living in wind-prone states pretty much pay their own way through high homeowner rates. Texas and Florida and other coastal states have the highest homeowner insurance rates in the country. (Chart 3)

Disaster relief is not paid for on a risk related basis, however. Taxpayer subsidy from state to state is very real and varies depending upon the level of insurance coverage in the particular state. Chart 4 shows the per household subsidy from state to state. It is quite unfair for the citizens of some states who pay their own way on disasters to be asked, time and time again, to fund damage of others who do not carry insurance.

I have supplied 25 copies of CFA's new study, "America's Disastrous Disaster 'System'" to your staff, Mr. Chairman. We find that there is no real system in place in the nation to handle disasters. As a result, the nation rocks from crisis to crisis, sometimes with almost complete insurance coverage provided privately, sometimes with some federal insurance in place, sometimes with no insurance, only post-disaster relief.

The mitigation and enforcement systems also are different depending on the disaster. The building standards for flood-prone areas are set nationally, by the Federal Emergency Management Agency (FEMA). But for wind and earthquake the building codes are under state or local control resulting in wide disparities in standards and level of enforcement from place to place. Enforcement is a vital aspect for consideration in design of national disaster policy. For instance, had the standards in place been enforced where Hurricane Andrew struck in Florida, the damage would have been reduced by 40% to 70%.

Our research shows that safe building and the maximization of private insurance and reinsurance can sharply reduce the tax burden of disasters and can eventually largely eliminate them (except for immediate shelter and other emergency needs). Congress should develop and adopt a plan to accomplish this prior to enacting any legislation which further exposes taxpayers. We are concerned about moving forward with a bill absent full understanding of the impacts on consumers, taxpayers, insurers and other stake holders.

Principles to Guide a National Disaster Policy

The nation needs a new system, an integrated system, to handle the disaster risk. But the proposals under consideration focus too much on providing relief to the insurance industry rather than ensuring consumers have greater protection against loss and that losses are reduced through safer building practices. Congress should not enact any legislation that provides taxpayer back-up to the insurance industry unless the legislation meets the following principles to ensure that it benefits consumers and taxpayers as well as insurers:

Adequate Insurance Protection

- Any proposal must ensure that adequate insurance is available at adequate rates to all consumers, especially in high-risk areas. A transition plan may be needed to help current homeowners get through the "sticker shock" of changes in prices for their insurance in some areas.

- Low and moderate income homeowners should be protected from loss of insurance coverage.

- Deductibles, co-insurance and surcharges may all be ways to ensure that

insurance is available but should not be used to render coverage levels meaningless. Congress should deal with the problem that it now has where insurers have sharply raised deductibles so that the taxpayer is now at risk for disaster relief *under* the point at which private insurance begins. This development will sharply increase tax liabilities after future catastrophes.

•To discourage development in high-risk, disaster-prone areas, insurance coverage for new construction should be based on the risk, minimizing cross subsidies.

Strong Mitigation Measures to Reduce the Costs of Disasters

•Any proposal must have as its focus mitigation and must provide for effective measures to reduce losses. To back up insurance in high-risk zones without controlling new building practices in such zones foolishly would encourage unwise construction.

•All stake holders must be included in mitigation efforts -- federal, state and local governments, businesses and consumers, developers, the insurance industry and other stake holders.

•The proposal should promote building and relocation efforts away from high-risk areas.

•The proposal must include measures to encourage and assist homeowners, especially low-income homeowners, to implement damage-reduction measures.

The program should encourage innovative ways to reduce risk in existing homes.[2]

Retention of Risk in the Private Market

•Any program must have as its goal retaining as much of the risk in the private market as possible, taking into consideration the capacity of the market and the type of risk involved.

•The property/casualty insurance industry has over $300 billion in surplus (the excess of assets over liability). The industry has a great deal of capacity that should be drawn upon before calling on the public to help.

[2] As an example of an innovation to encourage retrofitting: If a program could be established that offered insurance rate discounts for retrofitting that would be sufficient to lower monthly cost by an amount which could be used for a loan to pay for the retrofitting, people could retrofit at no increase in monthly cash outflow. This would lower future disaster losses at no increase in cost to the homeowner.

A. M. Best, in its annual Review and Preview of January, 1998 said this: "By any ones' calculation the insurance industry is excessively capitalized." This should be reflected in any trigger of federal back-up Congress adopts.

•The very encouraging development of alternative private sources of back-up for the primary insurance companies such as tapping financial markets through Act of God bonds or other instruments to achieve securitization of catastrophe risk, must not be in any way impeded by the federal level of back-up.

Appropriate State and Federal Oversight

•Federal oversight of the insurance industry is essential if the federal government provides financial backup to the industry or states. For instance, the taxpayer should not be asked to back-up inadequately priced insurance. (An example of why federal oversight is required is the truly perverse design of the California Earthquake Authority -- see Appendix A).

•While the federal government must oversee the industry if it provides financial support, states must retain the ability to provide the appropriate protections for their residents.

Demonstrated Benefits to the Federal Government's Disaster Relief Expenditures

•Any proposal should reduce the cost of disaster relief by the federal government. A critical component of any sound bill should be a plan by Congress to show that the short-term investments taxpayers are asked to make in mitigation and back-up of insurance companies actually reduce their long-term tax liabilities from disasters. Congress should produce such a plan before enacting any legislation so that the nation can measure annual progress toward the end of minimizing taxpayer support for disasters.

The "Homeowners Availability Act of 1997" (H.R. 219) fails to meet the principles

HR 219 establishes a federal reinsurance program, the Disaster Reinsurance Fund, to be administered by the Department of the Treasury for state catastrophe pools that provide insurance in high-risk disaster prone areas. The reinsurance program would cover residential property losses from earthquakes, hurricanes and tsunamis. Under the bill, the maximum amount paid in any single year by the Fund is $25 billion. The bill permits the Fund to borrow funds from the federal treasury to cover insufficiencies in the fund.

The state pool would purchase insurance from the Fund to insure losses above the claims paying capacity of the pools. The Fund would be "triggered" when losses exceed $2 billion, $10 billion or any other amount the Secretary of the Treasury determines is appropriate.

There are several problems with the bill:

- The bill does not assure the taxpayer of any reduction in cost from safer building. With the exception of an untargeted minimum requirement for 5% of the state polls to be set aside for mitigation, there are no provisions to reduce the costs of disasters through preventive measures in the bill. Any program that calls on the federal government to assist the disaster insurance market should include mitigation measures that will reduce losses from disasters, e.g., enforcement of adequate building codes.

- H.R. 219 does not ensure that consumers in high-risk disaster prone areas get adequate insurance coverage. There are no provisions in the bill that require the pools to provide adequate coverage to consumers. The federal government should not provide financial back-up to state pools or insurance companies absent a guarantee that coverage will be available to consumers.

- The bill impedes the development of the private market. The triggers of as low as $2 billion are way too low and would clearly impede the development of private measures to cover catastrophe risks. The insurance company, USAA, has devised a plan just for it that covers at least $1.5 billion. A realistic trigger would be over the $16 billion of Hurricane Andrew, adjusted by the industry's surplus growth since January 1, 1992, plus a margin for encouraging the new securitization of risk that is going on.[3] The trigger should change year by year as the surplus of the industry and the other private solutions are established. At current levels, the trigger should be no less than $40 billion.

- The bill does not set standards for state pools which the taxpayer would back-up. Pools could be set up which actually increase taxpayer exposure. See Appendix A for a case study of the California Earthquake Authority for an example of a state pool which increases taxpayer liability.

Providing funding for state pools gives the insurance industry an incentive to dump more of their bad risks into the pools and to retain the best risks for their own accounts. This could result in less insurance coverage, transferring more of the costs of disasters onto the government, rather than using competition and the fast-developing securities back-up to reduce federal costs through maximization of private insurance.

[3] The surplus at the start of 1992 was $163 billion. Today it is over $300 billion. This is a factor of 1.84. $16 * 1.84 = $29.4. Given that over $1 billion of securitization and over $5 billion of new reinsurance is now available, I would add at least $10 billion to this amount. The trigger should be at least $40 billion.

The private market can provide coverage for much more than this bill assumes. It handled Hurricane Andrew, Northridge and grew in size and strength at the same time. Much of the insurance industry does not need this bill. The insurance companies that primarily advocate the bill, Allstate and State Farm, sold homeowners and other types of insurance with reckless abandon in the 1980s in high risk areas creating an oligopy in Florida, according to that state's Academic Task Force which studied this matter. Now they want off the hook by dumping their risks onto the taxpayer. It is not the right way for Congress to deal with this important topic. The nation does not need a bail out of insurers, the nation needs a thoughtful national program to reduce risk and maximize private sector insurance coverage in a competitive market.

Good News for Natural Disaster Policy and Research

The interest Congress has shown in this important issue has led to a national debate on the subject. This debate has resulted in many important positive developments:

- The Wharton School is conducting the type of research we have been calling for for several years, including looking into the capacity of the private sector to handle this risk, the impact of hypothetical large catastrophes on the market, and the effectiveness of mitigation and enforcement to control the costs of natural disasters. This research should help policy makers design a plan which reduces taxpayer liability for disasters and assures consumers have insurance protection at adequate prices.

- One of the most important early findings of the Wharton effort is that securitizing the catastrophe risk not only lowers the risk for the primary insurance company buying the back-up, but lowers the portfolio risk for the investor since the catastrophe part of the investor's portfolio is not coordinated with the movements of world financial markets.

- FEMA has prepared a National Mitigation Strategy. It is a beginning, but requires promotion and endorsement. Any bill should require safe building strategy as a condition of federal taxpayer back-up. To do otherwise is to invite unwise construction in high risk areas of the nation and increased taxpayer cost.

- The American Red Cross has incorporated natural disaster loss mitigation as a core program.

- Most property/casualty insurance companies are supporting the Institute for Business and Home Safety (IBHS) which focuses on the mission of natural disaster loss mitigation. It is disappointing to report, however, that about 1/3 of insurers, including some big names, have not become involved.

- Public Private Partnership 2000 (PPP2000) initiated by 19 federal agencies and IBHS is a series of 14 educational forums intended to develop the framework for formation of public and private partnerships to mitigate the effects of natural disasters. Bringing together all stake holders for joint thought and development of ideas is a very positive step indeed.

Conclusion

H.R. 219 in its current form fails to meet the principles of sound disaster policy. It does not assure availability of insurance to those who need it. It will interfere with emerging private sector solutions. It may exacerbate the current taxpayer subsidy to unwise building since it proposes no effective mitigation strategy. The trigger levels are too low. There are inadequate incentives for insurance companies to retain the risk. Worst of all, no analysis of the long term effects on consumers, insurers or taxpayers has been done.

Congress can, and should, do much better. You can adopt a plan that lowers the risk of death and property damage through mitigation, you can develop an integrated approach to insuring natural disasters that is fair to consumers of insurance, you can minimize federal involvement and maximize private solutions and you can set the nation on a course where, over the next few decades, the taxpayer will finally be off the hook for all but the emergency response part of the cost of natural disasters and people who choose to live in high risk areas will pay their own way.

I would be happy to respond to any questions you may have.

Appendix A

A Case Study of a State Pool Which Increases Taxpayer Liability
The California Earthquake Authority (CEA)

The California Earthquake Authority (CEA) is a plan to make earthquake insurance available in California. I represented the State of California in reviewing the actuarial aspects of this plan and found that the plan is not sound from an actuarial or a public policy viewpoint.

In the wake of the Northridge earthquake, the insurance industry became highly stressed. The 1994 Northridge, a $12 billion insured loss, followed shortly after the 1992 Hurricane Andrew at a time when the catastrophe reinsurance market was most tight -- reinsurance prices had skyrocketed and available coverage was restricted. The primary insurance industry was in a dilemma. There was concern that insurers would cut back on writing insurance.

The state adopted the CEA as a solution to this dilemma. The CEA relies upon a series of layers of capital to fund a maximum potential payout of $10.5 billion. Only $1.0 billion of that is contributed and in the hands of the CEA. The insurance companies have a contingent risk of $5.0 billion ($3.0 billion after the contributed capital is gone and a $2.0 billion layer from $8.5 to $10.5 billion of losses). Reinsurance in place covers $3.5 billion. Consumers will fund one billion via a bond if losses are very large.

The CEA is not well designed for several key reasons:

First of all, it contains no mitigation proposals or any encouragement for mitigation of new structures. Indeed, the rate structure for new construction discourages mitigation and encourages unwise construction in high risk areas.

This is because the rate structure is capped to limit the price in the highest risk areas of the state. For instance, one of the intermediate approaches of the CEA showed indicated rates by territory from $0.89 to $12.47. CEA capped the rates at $5.25. A $200,000 home gets an annual subsidy under this scheme of $1,444.

But this vastly understates the subsidies implicit in the CEA approach because even before these data just reported were developed, the CEA combined territories in a way to hold down costs to high risk zones. They also did not set rates by actual building location, soil type, slope and other risk factors which certainly could have been done for new construction. The result is a rate plan which invites construction in high risk areas and insures such unwise construction at rates significantly subsidized by consumers who live in low risk zones (these consumers have to pay an additional 8% to cover the subsidies to high risk homes).

While a degree of subsidy for existing structures may be desirable, particularly as as transition program to help current homeowners get through the impact of higher insurance costs, subsidy for new structures is a dangerous idea -- an idea that not only costs increased disaster costs in the future, but could mean additional loss of life in an earthquake.

Finally as to mitigation, the CEA has no real reward for retrofitting homes. Only a 5% discount is offered and only for older homes and only if these homes retrofit to current code standards. No help with the cost of retrofitting is offered by CEA. The retrofitting plan will not produce any real improvement in the existing housing stock.

The second reason the design of the CEA plan is not sound is the large shift of cost to the consumer and the federal taxpayer.

The 15% deductible eliminates coverage for most small earthquakes, placing all the cost of small earthquakes on consumers and taxpayers.

But even in large earthquakes, the shift to out-of-pocket cost by consumers and taxpayers is significant. For example, the CEA estimate of what it would pay out for damage to homes from the Northridge quake is $4.7 billion compared with the $7.6 actually paid out by the insurers after Northridge to homes. This is a 46% drop in benefits under the CEA approach.

The CEA witnesses in the rate case put forth 12 scenarios of various size earthquakes. The analysis revealed that the CEA would only pay for 37% of the damage to homes, ranging from as little as 28.6% to as much as 41.4%.

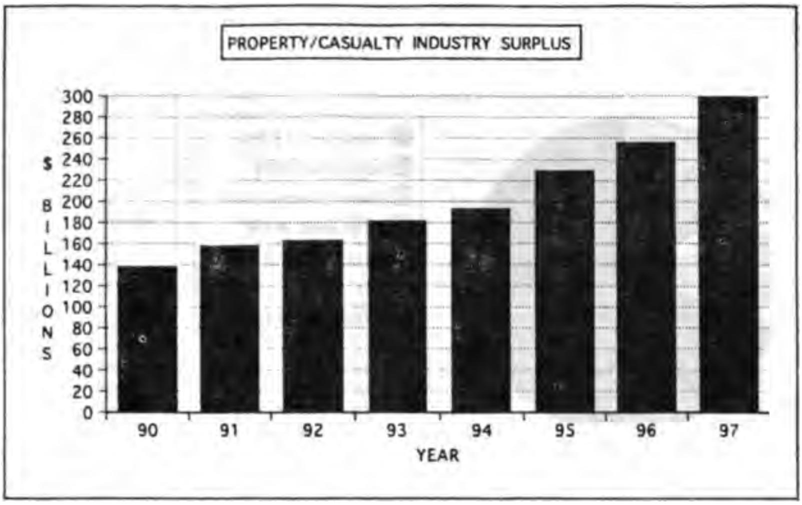
The bad coverage offered by the CEA will increase taxpayer cost when future earthquakes strike.

And, the CEA has been unsuccessful in getting many people to buy their policies. People understand that the coverage is awful so they figure, "Why buy it?" These newly "bare" homeowners will be looking to disaster relief exclusively for protection in the future.

Amazingly, while the CEA approach has explosively expanded federal taxpayer risk, the CEA has also been granted a tax exemption for reserves build-up. I really wonder about the wisdom of granting a tax exemption for the CEA given the fact that this plan produces an increased future taxpayer risk, not a lowered one.

If HR 219 passes CEA would have the taxpayer exposed at the bottom and top of the risk with CEA building reserves for the middle layer with taxpayer support in that layer as well. It is wrong to have the federal government paying first dollar coverage at all. A pool set up in the fashion that CEA is should not qualify for federal back-up.

CHART 1


PROPERTY/CASUALTY INDUSTRY SURPLUS
$ BILLIONS
300
280
260
240
220
200
180
160
140
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80
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20
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90
91
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95
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97
YEAR

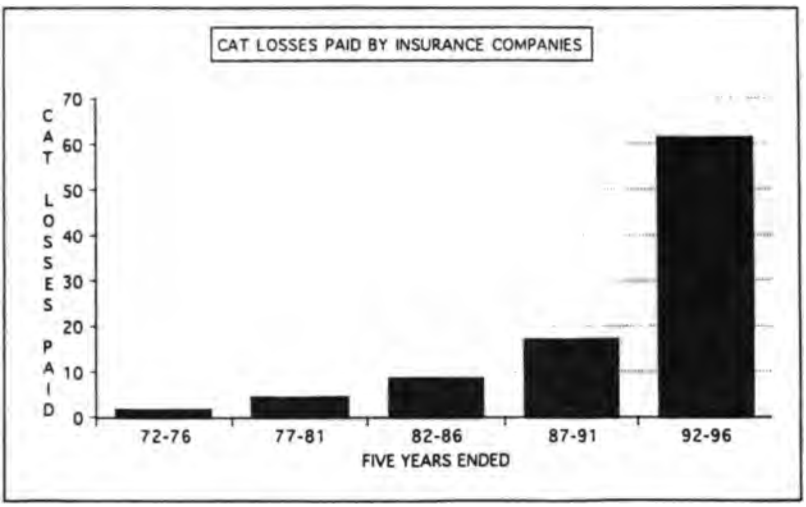
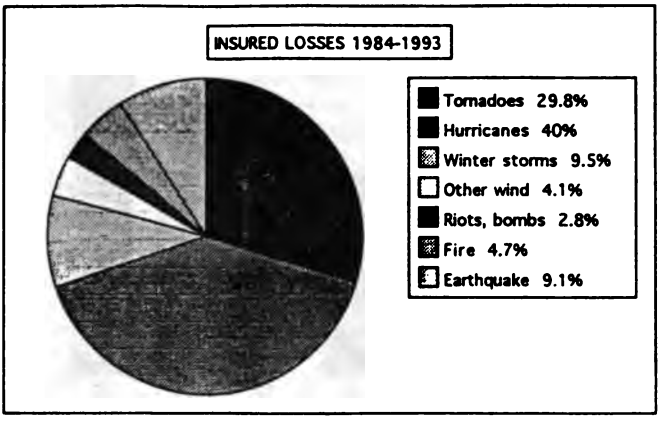
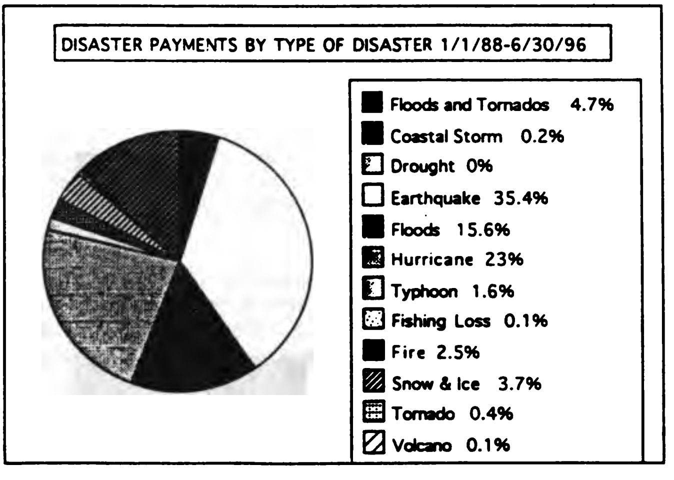

CAT LOSSES PAID BY INSURANCE COMPANIES
CAT LOSSES PAID
70
60
50
40
30
20
10
0
72-76
77-81
82-86
87-91
92-96
FIVE YEARS ENDED

CHART 2


INSURED LOSSES 1984-1993
Tornadoes 29.8%
Hurricanes 40%
Winter storms 9.5%
Other wind 4.1%
Riots, bombs 2.8%
Fire 4.7%
Earthquake 9.1%


DISASTER PAYMENTS BY TYPE OF DISASTER 1/1/88-6/30/96
Floods and Tornados 4.7%
Coastal Storm 0.2%
Drought 0%
Earthquake 35.4%
Floods 15.6%
Hurricane 23%
Typhoon 1.6%
Fishing Loss 0.1%
Fire 2.5%
Snow & Ice 3.7%
Tornado 0.4%
Volcano 0.1%

	A	B	C	D	E	F	G
1	HOMEOWNERS AVERAGE RATES BY STATE — RANKED BY RATE PER $1,000 VALUATION						
2		1995 AVERAGE	1995 AVERAGE	1995 AVERAGE		CHART 3	
3	STATE	HO-3 RATE	HO-3 HOME	HO-3 RATE		Page 1	
4			VALUE (000)	PER $1000 VAL			
5	Texas	785	104	7.55			
6	Mississippi	528	80	6.60			
7	Louisiana	628	99	6.34			
8	Oklahoma	536	86	6.23			
9	Arkansas	435	87	5.00			
10	Florida	543	109	4.98			
11	Kansas	464	94	4.94			
12	Wyoming	426	94	4.53			
13	South Carolina	465	107	4.35			
14	Alabama	391	90	4.34			
15	Nebraska	361	88	4.10			
16	Montana	400	98	4.08			
17	Alaska	556	138	4.03			
18	New Mexico	430	108	3.98			
19	Missouri	386	101	3.82			
20	Colorado	465	123	3.78			
21	Tennessee	383	102	3.75			
22	North Dakota	315	84	3.75			
23	South Dakota	303	82	3.70			
24	Utah	417	114	3.66			
25	Rhode Island	492	137	3.59			
26	Georgia	402	113	3.56			
27	Countrywide	418	119	3.51			
28	Hawaii	763	219	3.48			
29	Arizona	380	110	3.45			
30	West Virginia	328	95	3.45			
31	Iowa	300	88	3.41			
32	Nevada	441	130	3.39			
33	Michigan	351	104	3.38			
34	Vermont	414	126	3.29			
35	Kentucky	311	96	3.24			
36	Indiana	314	97	3.24			
37	Massachusetts	494	153	3.23			
38	North Carolina	362	113	3.20			
39	Minnesota	341	107	3.19			
40	New Hampshire	390	123	3.17			
41	Dist. of Col.	600	192	3.12			
42	New York	488	161	3.03			
43	Idaho	303	104	2.91			
44	Maine	307	108	2.84			
45	Connecticut	480	170	2.82			
46	Pennsylvania	340	121	2.81			
47	Washington	372	135	2.76			
48	Oregon	304	115	2.64			
49	Ohio	268	105	2.55			
50	New Jersey	436	176	2.48			

	A	B	C	D	E	F	G
51	Wisconsin	241	98	2.46			
52	Illinois	327	137	2.39		CHART 3	
53	Delaware	299	135	2.21		Page 2	
54	Maryland	322	146	2.21			
55	Virginia	283	132	2.14			
56	California	NA	NA	NA			
57							
58							
59							
60	Source: National Association of Insurance Commissioners:						
61	1995 Dwelling Fire, Homeowners Owner-Occupied, and						
62	Homeowners Tenant and Condominium Cooporative						
63	Unit Owner's Insurance; December, 1997.						

CHART 4

STATE	DISASTER RELIEF SUBSIDY PER HOUSEHOLD
12 STATES RECEIVE:	
North Dakota	$104.32
California	99.56
Hawaii	74.38
South Dakota	52.00
South Carolina	31.73
Iowa	25.69
Alaska	24.95
Florida	21.62
Louisiana	20.19
Missouri	4.57
Nebraska	3.31
West Virginia	0.10
OTHER STATES PAY:	
Georgia	-0.09
Mississippi	-2.36
Alabama	-5.75
North Carolina	-8.07
Kentucky	-11.83
Oregon	-12.22
Idaho	-13.11
Arkansas	-13.86
Washington	-15.36
Kansas	-15.40
Maine	-16.75
Oklahoma	-17.39
Minnesota	-17.73
Vermont	-20.60
Montana	-21.76
Arizona	-21.81
Illinois	-22.74
Texas	-23.41
New Mexico	-25.92
Tennessee	-27.40
Pennsylvania	-27.42
Wisconsin	-28.91
Indiana	-30.32
Utah	-30.48
Rhode Island	-31.22
Ohio	-32.62
Colorado	-34.66
Virginia	-35.57
Delaware	-36.06
Wyoming	-37.88
Massachusetts	-38.11
New York	-39.20
Michigan	-41.60
Nevada	-43.41
New Hampshire	-43.65
Maryland	-43.99
Dist. of Col.	-49.73
New Jersey	-51.71
Connecticut	-62.61
Countrywide	$ 0.00

CFA Consumer Federation of America

AMERICA'S DISASTROUS DISASTER "SYSTEM"

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JANUARY 1998

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AMERICA'S DISASTROUS DISASTER "SYSTEM"

Introduction

America has allowed its system for preparing and responding to natural disasters to grow in a haphazard way that inconsistently deals with natural disasters and which inadequately acts to save lives and property damage from natural hazards.

Consider the following inconsistent approaches to the three major hazards in America:

HAZARD	MITIGATION REQUIREMENTS	INSURANCE FROM:
FLOOD	Federal	Federal Government
WIND	State or local	Private (in Homeowners) or through State mandated Wind Pools or Joint Underwriting Associations
EARTHQUAKE	State or local	Private (separate policy) or through State Facility (California Earthquake Authority)

The lack of a planned, thoughtful approach to these problems puts our nation at risk -- leaving us vulnerable to sharply changing conditions, leaving taxpayers at great exposure, and resulting in unnecessary loss of life and property.

This paper takes an in-depth look at these three major hazards, the exposure society faces from them, how society covers the cost of these risks, current problems in covering the risks and why the current system needs to be changed. It also suggests how to move America toward a system that ends taxpayer subsidy of anticipated levels of damage, move the cost of high disaster risk to those who choose to live in high risk areas and minimize death and damage from unwise construction.

Societal Exposure

There has been tremendous growth in the costs of natural disasters in America as the chart below demonstrates. Since 1953, disasters over $100 million were declared from the Presidents's Disaster Relief Fund 18 times, of which 8 were in the 1990s. Of the $9.5 billion spent in disaster relief in these major events, $5.8 billion was spent in the 90s. For the total payouts for all size disasters, from 1980-1984, Federal Emergency Management Agency (FEMA) spent $2.6 billion; from 1985-1989 the cost

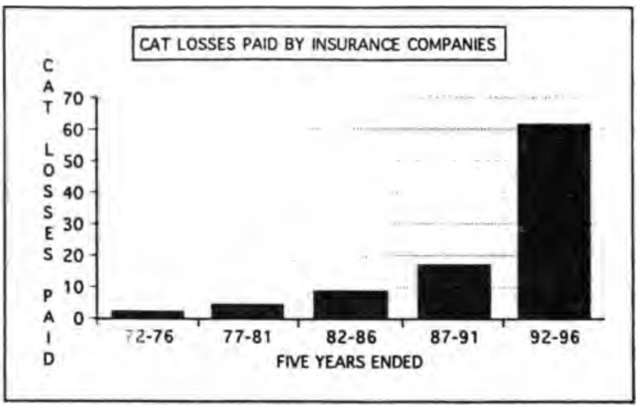
was $4.6 billion; from 1990 to 1994 the cost was $15.5 billion and for 1995-6, the cost was $8.4 billion (which translates into a greater than $20 billion clip on a five year basis).

The government costs would have been much greater, of course, had there not been significant payments made by private insurance companies for disaster losses.

During recent years, the insurance company catastrophe payments have also risen, viz:

FIVE YEARS ENDED:	CATASTROPHE LOSSES PAID BY INSURANCE COMPANIES[1]
1971	$ 1.3 billion
1976	2.1
1981	4.7
1986	9.0
1991	17.5
1996	61.4

Viewed graphically, one sees a remarkable growth in catastrophe payouts:



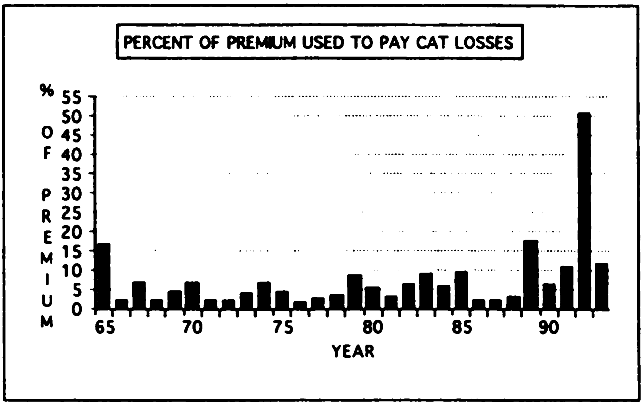
Of the top ten most costly insured losses of all time, only Hurricane Hugo (1989) was not a 1990s event.[2]

[1] See Exhibit 1, attached, for detail.
[2] Source: Insurance Information Institute, Insurance Issues Update, May, 1997.

A recent federal report found that the anticipated level of damage from hurricanes currently is $5 billion a year.[3]

Who Pays?

The question of who pays for natural disasters is an interesting one. For those who are insured, actuarial principles would require that risks pay their own way with actuarially sound prices. Over time, the percentage of premium used to pay for catastrophes varies, viz[4]:



1992 saw fully half of affected premiums[5] used to cover catastrophes. In a typical year, under 10% of premiums are so used. But the result is highly variable, causing great risk to be felt by primary insurance companies. This implies a great need to lay off, or "reinsure" a significant part of the risk.[6]

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[3] National Oceanic and Atmospheric Administration, November, 1997.

[4] Source: Table 2.4 of "federal Disaster Assistance," Bipartisan Task Force on Funding Disaster Relief, U.S. Senate. March 15, 1995.

[5] The premiums used in the calculation are fire, allied lines, homeowners' multi peril, farmowners' multi peril, and commercial multi peril. If all property/casualty premiums are used, the ratios are much lower. For instance, in 1992, the percentage of total P/C premiums related to catastrophe payouts for claims is 10.1% rather than 51.0% related to the selected lines of insurance used for this chart. It is important to note that, in 1992, when catastrophes hit the insurance industry with this 10.1% impact on the bottom line, the industry still enjoyed a growth in surplus. This powerful performance related to investment returns and to the federal tax help the industry got at the end of the year (a form of federal subsidy not included in the disaster relief payments cited earlier in this report.

[6] Reinsurance is a sort of lay off bookie arrangement where the primary insurance company insures itself with a secondary market insurance company. This second insurance company insures the insurance the first insurance company wrote. Insuring insurance is caller "reinsurance."

\1992 was the year of Hurricane Andrew, of course. Andrew was unique, a $15.5 billion event for the insurers. Hurricane Hugo (1989) was the previous record payout, at $4.2 billion.

Payment for disasters depends upon whether they are fundamentally insured or not. Insured events will, over time be borne by those who are at risk. As Exhibit 2 shows, insurance catastrophe loadings -- the amount in rates for catastrophe costs -- vary by state. The five highest paying states are Hawaii (8.56% of premiums), Florida (7.73%), South Carolina (5.22%), Kansas (4.51%) and Oklahoma (4.16%).[7]

Of course, in the short run, insurance involves a sort of "cross subsidy", from those who do not suffer the loss to those that do. In the long run, given the nature of the competitive market in insurance, prices will reflect risk. Insurance subsidies may exist, but they are minimized by state regulatory practices which only allow small impact, if any, of disasters from other states. However, within a state, cross subsidies may exist (such as between the coast of Florida and those living in the north-center of the state; between those with little exposure to risk of earthquake in California and those with the largest risk[8]).

The insurance industry has complained about regulation suppressing disaster insurance rates, but that is not a significant factor. Since insurance companies can reject risks through underwriting, the regulator has little opportunity to hold rates too low. Indeed, the problem of rates being too low prior to Hurricane Andrew in Florida can be shown to be caused by industry desire for market share, not suppression by the regulators.

But disaster relief payments involve cross subsidy from those not exposed to those who are exposed with no or inadequate private or public insurance. There is no risk testing in the collection of federal taxes. Therefore there is no surcharge on taxes for living in a high risk area.

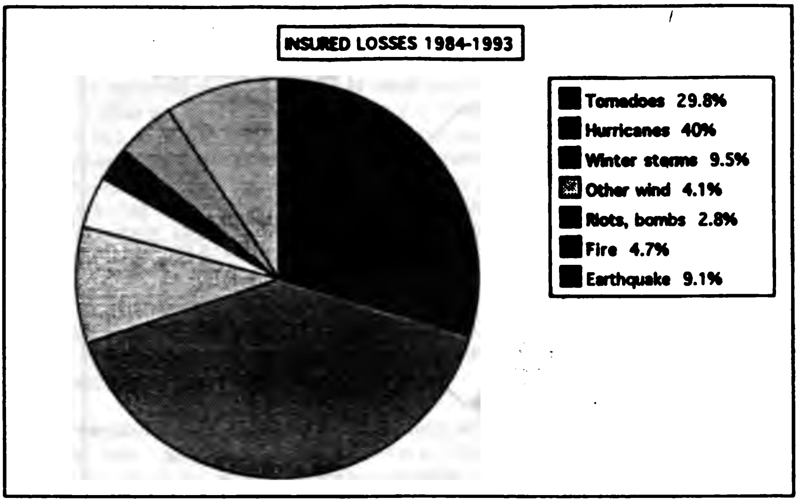
Exhibit 3 shows the Federal Emergency Management Agency (FEMA)/SBA disaster relief payments made by state from 1988 to 1996. California received $13.1 billion in assistance, 46% of the national total. Florida, albeit Hurricane Andrew is in this time frame, received $2.5 billion, 9% of the national total over the period. A major reason is that Hurricanes are covered in the Homeowners and other fire-related insurance policies, but earthquake is not.

[7] The National Association of Insurance Commissioners approach is based on historical experience for all perils except flood (including hail, tornado, hurricane and earthquake). Other approaches involving modeling, such as the rate loads for catastrophe adopted by the Insurance Services Organization might also be used for this sort of analysis.

[8] Indeed, the California Earthquake Authority explicitly filed for such a cross subsidy in its first rate request. This dangerous precedent could lead to unwise construction since the subsidy applies not only to existing construction, but to new construction as well.

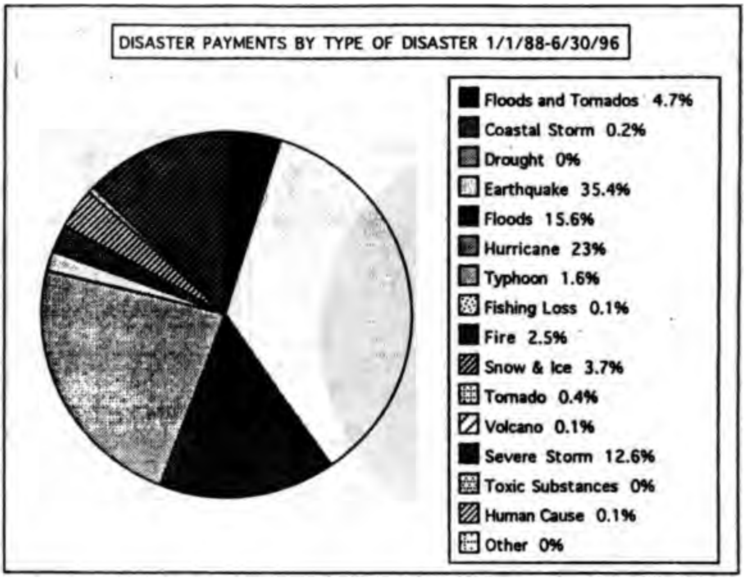
Consider the breakout of payments for insurance vs. disaster relief:

INSURANCE:



It should be noted that this excludes the National Flood Insurance Program loss payments.

DISASTER RELIEF:



Looking at the major payout comparisons:

Type of Disaster	Relief payouts	Private Insurance payouts
Earthquake	35.4%	9.1%
Floods	15.6	0
Hurricanes	23.0	40.0
Severe Storms	12.6	4.1
Tornadoes	5.1	29.8
Ice/Snow	3.7	9.5
Other Disasters	4.6	7.5
Total	100.0%	100.0%

Insurance takes care of smaller wind events such as tornadoes almost completely. Insurance covers a significant portion of the larger wind events, too. Federal Flood Insurance has been rightly criticized for failing to make necessary market penetration to reduce tax support, albeit, between 1977 and 1993, it paid out $6.8 billion requiring only a $3.0 billion governmental outlay.[9]

State cross subsidies in disaster relief are apparent (See Exhibit 4). For example, California received over $13 billion of relief for disasters in the 1988-1996 period, which, related to the tax base was about 2.4 cents back per dollar of tax paid. New Mexico, DC, Colorado, Utah and Wyoming got back under $10 Million in the period, representing under 0.1 cents per dollar of tax paid. Exhibit 4A shows an estimate of the subsidy by state in dollars per household per year. Receiving the largest subsidies are ND ($104), CA ($100), HA ($74), and SD ($52), . Paying most are CT ($63), NJ ($52), DC ($50), MD ($44), NH ($44) NV ($44), MI ($42), NY ($39), MA ($38) and WY ($38). Note that, because they pay there own way through insurance, Florida had a relatively low $22 per household subsidy, even with Hurricane Andrew's impact.

Indeed, one state, California, has received 46% of the disaster dollars spent by the government in recent years, over five times the dollars flowing into the second highest collecting state, South Carolina at 9%.

Very interestingly, as Exhibit 5 shows, farmers and farm corporations fare well under disaster relief. 58% of disaster relief dollars in the total disaster picture for 77-93 were paid out by the US Department of Agriculture or by FmHa, compared to 24% for small businesses and about 12% for families.[10]

The federal government does run two disaster-type insurance programs, the National Flood Insurance Program (NFIP) and the Federal Crop Insurance Program.[11] While still a money loser, the NFIP is predicated on a plan to reduce taxpayer subsidy as new construction must meet federal building codes in high flood hazard areas of maps produced by the government.

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[9] The National Flood Insurance Program (NFIP) is a federal program run by the Federal Insurance Administration (FIA), housed in the Federal Emergency Management Agency, which sells flood insurance in participating communities. In order to participate, communities must enact land use and control measures for those parts of the community found to have high flooding risk according to FIA maps. New structures, built after the map is published in the community, must pay full, unsubsidized, actuarial rates. Market penetration problems have been exacerbated by the public perception that "it can't happen to me" and the expectation of federal bailouts "if it does happen to me." Another problem has been the lack of a requirement for banks to maintain insurance coverage after the initial year of coverage.

[10] Research of farm disaster relief payout detail by state was beyond the scope of this report but is research which should be undertaken.

[11] The results of the programs are as follows (1977 to 1993 cumulative data, 000 deleted):

	FLOOD PROGRAM	CROP PROGRAM
PREMIUMS	$ 8,426	$ 7,324
LOSSES	6,835	13,451
EXPENSES	4,533	3,862
GOVT OUTLAY	2,992	9.989

Coverage Historically

Insurance coverage for Earthquake and Wind has normally been made available privately (flood insurance was never widely available through private sector). In the era leading up to the recent spate of large disasters, there was a rush to write all risks, including catastrophic risk. Aggressive competition was the order of the day, even in high risk hurricane and earthquake zones.[12]

When California first required review of fault exposure in the late 1970s-early 1980s, the reaction of the insurance companies was a panic -- they had unknowingly written freely along faults (interestingly, while they had undeserved such areas as South Central Los Angeles[13]). In Florida, following Hurricane Andrew, companies started to retrench. Allstate even threatened to terminate 300,000 policies until the state stopped that with a moratorium on terminations. A state task force found that, in the period leading up to Andrew, Allstate and State Farm had wildly competed themselves into a market characterized by the task force as an oligopy. In great measure, the insurers brought trouble onto themselves by careless writing, not paying enough attention to proper spread of catastrophic risk.

Similar findings of insurance industry self-inflicted problems in the catastrophic insurance market were reported by Conning & Company. Conning determined that not only aggressive writing, but expansion of coverage under the Homeowners' Policy led to the high costs. The biggest change, Conning found, was the expanded use of replacement cost policies for homes and contents. Further, Conning found that the cost of insuring homes fell by 40% per $100,000 of coverage between 1984 and 1995.[14]

How The System Has Worked Quantitatively

Insurance has paid more of the cost of disasters than the federal government disaster programs have. In the decade 1986 to 1995, disaster payouts have been about $66 billion, whereas private insurance payouts have been $72 billion. Out of pocket costs[15] have not been estimated, but are large and getting larger as both the insurance industry and the government try to tighten up their belts as respects disaster exposures. For example, in California, earthquake policies are now written by the California Earthquake Authority which, like other insurers writing earthquake insurance, uses a "mini-policy" with sharp coverage restrictions. The most noteworthy

[12] The homeowner's insurance market was very "soft" (that is, characterized by low price and easy availability of insurance) for many years leading up to 1992. Hurricane Andrew turned the market "hard" (that is high in price and difficult to obtain coverage, particularly near coasts and earthquake faults).

[13] See studies of California Department of Insurance following Los Angeles Riots, 1992.

[14] Conning & Co., November, 1996.

[15] Out of pocket costs are due to lack of insurance, inability to buy insurance, large deductibles, coverage restrictions imposed in so-called "mini-policies" and other coverage restrictions.

restriction is the deductible of 15%. Estimates there are that consumers (and/or taxpayers) will pay about 63% of earthquake claims under the new California Earthquake Authority limited policies.[16]

In recent years the consumer has had difficulty in seeking coverage in high risk areas for private coverage (Federal Flood Insurance is always readily available). Following the large recent disasters, Insurance companies have moved in the direction of significantly higher prices and much narrower coverage for catastrophes. Insurers have cut their exposure using some of the following strategies:

- limits on coverage, such as increasing deductibles and the advent of intra-policy coverage controls, such as the "mini-policy" used to write earthquake coverage in California
- rate hikes, based on new models (often without disclosing the model or the assumptions used in the model) rather than using the historic methods of relying on state long-term data[17]
- changed underwriting (eg Allstate pullout in Florida; coastal pullouts; other adjustments; quotas by region for some carriers)
- creation of plans to get insurance companies off the hook for risk (Florida JUA, California Earthquake Authority)
- role of reinsurance in market stability over recent years -- first a significant tightening of the reinsurance market, now an easing, even recent rate reductions
- creation of new ways to spread risk (USAA and other insurers looking to the securities market to spread the catastrophe costs)

It appears evident that the insurance market overreacted in the wake of Hurricane Andrew. But it has been righting itself. Reinsurance was the most exposed area of the insurance market. It retrenched very severely following Andrew. But it has come back with a vengeance. The Bermuda reinsurance market raised $4.5 billion in capacity in 1994 alone. Prices for catastrophe reinsurance began to fall in early 1995 and that trend continues to this day. Securitization of insurance risk began in 1995 when Nationwide Mutual Insurance Group secured $400 million in backup from Morgan Stanley and other investors. "Act of God" bonds, hedges and derivative approaches to the problem were created in 1995. In 1996 and 1997, this trend continued with several major insurers, including USAA, obtaining new mechanisms to spread the risk

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[16] Testimony of J. Robert Hunter in the Matter of the Rate Filing of the California Earthquake Authority, April 14, 1997. CEA has not called for upgraded building codes nor offered meaningful incentives for private mitigation efforts.

[17] CFA believes that use of models is a step forward, scientifically. However, the assumptions involved must be made public for all to see and debate, to assure that the models do not hide improper techniques to determine prices. Instances of different modelers producing widely different results is troubling. Altered assumptions should be made public for consumers to have confidence in actuarial pricing so that cross subsidies can be minimized.

or spread the cost of unusually high catastrophes.[18]

Critique of Existing "System"

Simply put, there is no "system" in place to systematically deal with disasters in the United States of America. But there should be. The nation rocks along from disaster to disaster, with the President or Vice-President dutifully flying over each major disaster with the governor and mayor and the Federal Emergency Management Agency (FEMA) Director, bringing with them checks to hand out.

This is not a "system". This is a tragedy. You would think that once, as he flies over yet another tragedy, the President (not just Clinton, but all the Presidents, Democrat or Republican, who have been in that helicopter over and over again for decades) would say, "Wait a minute. What are we doing? How can we help the current victims, yes, but move the nation toward a rational plan to lower damage and loss of life and ultimately get the taxpayer off the hook for all these costs?"

The current "system" is a prescription for Disaster, not a prescription to avoid a disaster. Only in the National Flood Insurance Program is there required safe building standards in place. There are no national wind or earthquake standards.

Nor are there national enforcement tests of any standards that are in place. Studies after Hurricane Andrew indicated that, had the standards in place in Florida been enforced, damage would have been reduced by 40%.

California's new earthquake facility, the California Earthquake Authority, not only has adopted no building standards, it has no research underway to even test existing codes or enforcement of such codes. Worse, the rating plan has cross subsidies built into it, even for new construction, an invitation to builders to build in higher risk areas.

There have been some self-serving attempts to broaden the national perspective on disaster. In the 1980s, the insurance industry created an entity, the Earthquake Project, to try to obtain access to the treasury in the event large earthquakes happened. That project was expanded, and the name changed to the Natural Disaster Coalition, following Hurricane Andrew in 1992. But it remained committed less to a real solution than to a guarantee to bail out private insurance interests if a large event occurred. Wisely, Congress never acted on the bills put forth by either the Earthquake Project or its successor organization.

[18] See, e.g., "Private Sector Responses to U.S. Natural Disaster Threats," Reinsurance Association of America, April 15, 1997 for a through look at innovative ways capital is being made available to back up catastrophic risk privately. The USAA deal was the purchase of $400 million of reinsurance from a special purpose reinsurer (SPR), backed by catastrophe bonds. The SPR acts as a transformer, the real risk is borne by the bonds. USAA will be reimbursed for a loss of between $1 and $1.5 billion from a single Class 3, 4 or 5 hurricane in the 21 covered Atlantic and Gulf Coast States, with USAA taking 20% of the layer.

The problem faced by the nation is obvious. We need an integrated plan to, over several decades, assure that the taxpayers interests are protected and that damage and loss of life are reduced to a minimum.

This requires careful analysis to determine a comprehensive plan to (1) mitigate damage through enforced, national minimum standard building controls, (2) determine how to maximize private responses (be it traditional insurance or innovative ways to securitize risk) to natural disaster claims, (3) eventually eliminate taxpayer liability for natural disaster and (4) assure generally available, affordable insurance protection to all, including mechanisms to include the low income persons in high risk areas.

Solutions with no study not appropriate

Congress wisely has resisted solutions with no analysis undergirding the proposals. It would be worse than inappropriate for Congress to enact a plan that backed up private insurance with no analysis of how to mitigate risk, no time-line for the removal of taxpayer support, no enforcement guarantees as to building codes and no guarantee that safely built structures would be able to be protected from natural disasters through insurance or other affordable approaches.

Approaching a Solution

The only way to approach a solution is by careful study. The nation needs the answers to such questions as:

* Do we really need to do this for windstorm? After all, the private sector has handled wind for all time, including Hurricane Andrew, without a federal program and the catastrophe reinsurance market is robust today. Careful study in Florida showed that the availability problem in that state has a lot to do with the fact that the homeowners insurance market is over concentrated in two insurers, Florida study shows that in a relatively brief time, that state can garner the resources to handle its own problem. What states really need federal back-up in the long run? The Florida study makes it clear that the State would have fared much better if codes were enforced. Does this means that nationally enforced building codes should be adopted or are there other enforcement tools -- perhaps private approaches -- that can assure safe building occurs?

* What are the long term ramifications of the proposal? Where is the cost/benefit analysis? How does the mitigation component really work over time? When can the taxpayer really expect to get off of the hook in this program? Do we need temporary direct or cross subsidies? Who pays the subsidy? Who receives the subsidy? How can insurance be structured to encourage mitigation efforts by policyholders through price discounts, lower deductibles, etc.? Can a plan be devised which would combine a loan for the

cost of the mitigation with an insurance price discount so that the homeowner who chooses to mitigate would actually see a lower net monthly payment for the loan/premium combination?

* Does Michigan subsidize California more or less than Michigan does today under the current disaster relief approach? Who gets subsidy and how much? Who pays subsidy and how much? Will the people who chose to inhabit high risk zones ever fully pay their own way?

* As to mitigation, what is the state of the art standards that will be required? Who enforces it? Who gets it by the builders, with their focused economic interest and powerful lobby at the local and state level? Is just one standard required or should it vary by place? Should there be federal minima that must be met for a state or locality to qualify for the insurance or reinsurance? To what extent should mitigation be required vs. encouraged by financial incentives? Does the answer to this depend on whether we are considering mitigation on a new or an existing structure?

* Should there be one plan for all catastrophic hazards or is the issue different coverage by coverage? How should the National Flood Insurance Program be integrated into the overall plan? What are the lessons from the NFIP that should be instructive in developing the overall plan? Was the NFIP good legislation? How has it worked to get mitigation in place? Have lives and property been saved?

* What alternatives to traditional insurance can be developed to spread the risk beyond insurance to the far greater securities markets?[10]

* What happens to those who must buy the insurance under the purchase requirements of the bill but can't afford the price? Is this the right way to force spread of risk? Should there be some transition plan similar to the existing structure subsidies used when the National Flood Insurance program was enacted? Study of the rather tiny benefits being offered under California's so-called "Mini-policy" for earthquake and the likely adverse ramifications on the public and the taxpayer of sharp coverage limitations should be part of the analysis.

[10] Research indicates that a large natural disaster might use up one-third of the insurance industry's surplus, but the same loss would only represent about 1% of the security value traded on U.S. stock markets. Indeed, the addition of securities covering natural disasters to investor's portfolios would reduce the risk of a securities portfolio, given the counter-cyclical nature of natural catastrophes (i.e. not moving with giant market movements -- known as a zero beta). See Can Insurers Pay for the "Big One"? Measuring the Capacity of an Insurance Market to Respond to Catastrophic Losses, J. David Cummins and Neil A Doherty, The Wharton School, December, 1997.

Before the flood insurance program was enacted, Congress did the right thing. It undertook a feasibility study under the leadership of the National Academy of Sciences that carefully answered the questions that attended to the flood risk. This sort of impartial study is needed to determine of what sort of federal back-up, if any, is needed for this country's insurance industry for natural disaster, what appropriate mitigation measures should be employed, what other quid-pro-quos should be exacted to protect taxpayers and answers to many other fundamental questions.

The Wharton School has begun such an effort. This study could answer many of these and other important questions.

There is also hope for movement toward informed future action in these recent developments:

- The Federal Emergence Management Agency has prepared a National Mitigation Strategy. It is a beginning, but requires promotion and endorsement so it is not too little and too late.

- The American Red Cross has incorporated natural disaster loss mitigation as a core program.

- Most property insurers are supporting the Institute for Business and Home Safety (IBHS) which focuses on the mission of natural disaster loss mitigation. It is surprising that about one-third of insurers, including some big names, have not become involved.

- Public Private Partnership 2000 (PPP2000) initiated by IBHS and 19 federal agencies (coordinated by the Subcommittee on Natural Disaster Loss Reduction) consists of 14 educational forums intended to develop the framework for formation of public and private partnerships to mitigate the effects of natural disasters. Bringing together all of the stake holders for joint thought and development of ideas is a very positive step.

Political Dilemma -- Solutions Possible

Naturally, the ultimate solution will require political compromise. It is no surprise that support for an earthquake-only solution gained support only from California's congressional delegation. When the Earthquake Project metamorphosed into the Natural Disaster Coalition after Hurricanes Andrew and Iniki in 1992, it is no wonder that the support came from California, Florida and Hawaii's Congressional delegations.

EXHIBIT 1

DISASTER PAYOUTS BY INSURANCE COMPANIES IN THE U.S.A.

YEAR	CAT LOSSES[1]	YEAR	CAT LOSSES
1965	$ 694 Million	1981	714 Million
1966	111	1982	1,529
1967	327	1983	2,255
1968	135	1984	1,548
1969	256	1985	2,816
1970	450	1986	872
1971	174	1987	905
1972	215	1988	1,409
1973	376	1989	7,642
1974	696	1990	2,825
1975	514	1991	4,723
1976	271	1992	22,970
1977	423	1993	5,705
1978	646	1994	17,010
1979	1,703	1995	8,310
1980	1,177	1996	7,375

[1] Source: Property Claims Services Division of American Insurance Services Group, Inc. Actual payouts. These payouts include commercial insurance as well as insurance on homes.

INS. CAT LOADS BY STATE

Exhibit 2

STATE	PREMIUM FACTORS (%)	STATE	PREMIUM FACTORS (%)
Hawaii	8.56	Virginia	0.95
Florida	7.73	Tennessee	0.93
South Car.	5.22	Minnesota	0.89
Kansas	4.51	Pennsylvania	0.84
Oklahoma	4.16	Oregon	0.76
California	3.49	Ohio	0.76
Texas	3.22	New York	0.76
Colorado	3.17	Maryland	0.7
Louisiana	3.07	Washington	0.62
Mississippi	2.94	New Jersey	0.62
Alabama	2.78	Maine	0.62
Nebraska	2.47	Vermont	0.61
Rhode Is.	2.32	Wisconsin	0.58
Arkansas	2.29	Alaska	0.55
North Car.	1.85	New Hampshire	0.43
Wyoming	1.75	Arizona	0.39
Delaware	1.75	Utah	0.35
Iowa	1.65	Michigan	0.29
Missouri	1.61	Idaho	0.21
South Dakota	1.45	Dist. of Col.	0.2
Georgia	1.42		
Kentucky	1.41		
Connecticut	1.31		
North Dakota	1.28		
West Virginia	1.27		
New Mexico	1.24		
Indiana	1.24		
Nevada	1.23		
Massachusetts	1.11		
Illinois	1.09		
Montana	0.97		

Source: New York Insurance Department Catastrophe
Premium Reserve Factors, 5/14/97
(used unadjusted factor as proxy for cat costs)

FEMA/SBA
TOTALS
DISASTER
RELIEF
1988-96

EXHIBIT 3

$ MILLIONS	STATE	$ MILLIONS	STATE
13061.7	California	103.2	Oklahoma
2491.5	Florida	86.8	Arkansas
859.2	Illinois	55.2	Maryland
736.8	Texas	54.2	Connecticut
706.9	Georgia	53.3	Idaho
618.7	South Carolina	52.6	Maine
602.5	Missouri	35.8	Michigan
590	Louisiana	30.9	Nevada
511.1	North Carolina	21.3	Vermont
471.8	New York	20.5	Rhode Island
467.9	Iowa	17.2	Delaware
444.2	Washington	14.9	New Hampshire
425.8	Pennsylvania	14.5	Montana
410.5	Hawaii	8.5	New Mexico
304	Minnesota	8.2	Dist. of Col.
293.1	Alabama	4.8	Colorado
231.1	North Dakota	2.6	Utah
204.8	Oregon	0.4	Wyoming
195.9	Massachusetts		
186.3	Kentucky	28289.9	Countrywide
172.7	Nebraska		
164.6	Ohio		
163.3	South Dakota		
160	New Jersey		
154.4	Mississippi		
153.5	Kansas		
137.6	Arizona		
136.9	Virginia		
134	Wisconsin		
133	West Virginia		
130.1	Tennessee		
129.6	Alaska		
128.4	Indiana		

EXHIBIT 4

DISASTER RELIEF PAYMENTS AS A PERCENTAGE OF FEDERAL TAXES PAID – 1/1/88 TO 6/30/96

STATE	DISASTER PAY AS A % OF TAX	STATE	DISASTER PAY AS A % OF TAX
North Dakota	2.9	Oklahoma	0.3
California	2.4	Maine	0.3
Hawaii	2.0	Arkansas	0.3
South Dakota	1.8	Arizona	0.3
South Carolina	1.5	Wisconsin	0.2
Louisiana	1.2	Tennessee	0.2
Iowa	1.2	Pennsylvania	0.2
Florida	1.1	Montana	0.2
Alaska	1.0	Massachusetts	0.2
Nebraska	0.8	Virginia	0.1
Missouri	0.8	Rhode Island	0.1
West Virginia	0.7	Ohio	0.1
Georgia	0.7	New York	0.1
Mississippi	0.6	New Jersey	0.1
Alabama	0.6	New Hampshire	0.1
Washington	0.5	Nevada	0.1
Oregon	0.5	Maryland	0.1
North Carolina	0.5	Indiana	0.1
Minnesota	0.4	Dist. of Col.	0.1
Kentucky	0.4	Delaware	0.1
Kansas	0.4	Connecticut	0.1
Illinois	0.4	Wyoming	0.0
Idaho	0.4	Utah	0.0
Vermont	0.3	New Mexico	0.0
Texas	0.3	Michigan	0.0
		Colorado	0.0
		Countrywide	0.7

Note: Taxes for 1/1/95 to 6/30/96 estimated to be at 1994 levels.

48-232 98 - 15

EXHIBIT 4A

ESTIMATED PER HOUSEHOLD[1] CROSS SUBSIDY BETWEEN STATES FOR DISASTER RELIEF 1/1/88 TO 6/30/96

STATE	SUBSIDY PER HOUSEHOLD	STATE	SUBSIDY PER HOUSEHOLD
12 STATES RECEIVE:			
North Dakota	$104.32	Vermont	-20.60
California	99.56	Montana	-21.76
Hawaii	74.38	Arizona	-21.81
South Dakota	52.00	Illinois	-22.74
South Carolina	31.73	Texas	-23.41
Iowa	25.69	New Mexico	-25.92
Alaska	24.95	Tennessee	-27.40
Florida	21.62	Pennsylvania	-27.42
Louisiana	20.19	Wisconsin	-28.91
Missouri	4.57	Indiana	-30.32
Nebraska	3.31	Utah	-30.48
West Virginia	0.10	Rhode Island	-31.22
		Ohio	-32.62
OTHER STATES PAY:		Colorado	-34.66
Georgia	-0.09	Virginia	-35.57
Mississippi	-2.36	Delaware	-36.06
Alabama	-5.75	Wyoming	-37.88
North Carolina	-8.07	Massachusetts	-38.11
Kentucky	-11.83	New York	-39.20
Oregon	-12.22	Michigan	-41.60
Idaho	-13.11	Nevada	-43.41
Arkansas	-13.86	New Hampshire	-43.65
Washington	-15.36	Maryland	-43.99
Kansas	-15.40	Dist. of Col.	-49.73
Maine	-16.75	New Jersey	-51.71
Oklahoma	-17.39	Connecticut	-62.61
Minnesota	-17.73		
		Countrywide	$ 0.00

[1] Households estimated by dividing population of state by 2.7 persons per household

Independent Insurance Agents of America

Incorporated

TESTIMONY OF:

CHARLES T. BROWN
ON BEHALF OF THE
INDEPENDENT INSURANCE AGENTS OF AMERICA
BEFORE THE HOUSE
COMMITTEE ON BANKING AND
FINANCIAL SERVICES

APRIL 23, 1998

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Suite 300
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Mr. Chairman, thank you for this opportunity to address the Committee on the need for natural disaster legislation. My name is Charles T. "Charlie" Brown. I am Vice President of Baker Welman Brown Insurance in Kennett, Missouri. Kennett is a small town of approximately 11,000 people located in the boot heel of Missouri. I am an independent insurance agent in this community and have the privilege of representing hundreds of homeowners with all different types and values of homes. I am testifying on behalf of the Independent Insurance Agents of America.

You may wonder why an independent insurance agent from Missouri is concerned about natural disasters since this problem would appear to concern only homeowners who have built houses near the ocean or live on the San Andreas fault in California. It is a long trip from Missouri to Washington, D.C., but I want to share with you what my clients and many average homeowners in Missouri are facing.

NEW MADRID FAULT

Unfortunately, my town is located in what is predicted to be the worst affected area of the New Madrid fault. For those who are unfamiliar with the fault, it crosses five state lines and the Mississippi River in at least three places. Damage estimates for a major earthquake on the New Madrid fault run into the billions of dollars. A major event would devastate St. Louis and Memphis and impact thousands of homeowners in Arkansas, Illinois, Kentucky, Tennessee and Missouri. Still, my agency, since its beginning in 1939, has never seen enough damage to a home from a minor tremor to pay an earthquake claim. But, the ripples and tremors from the enormous potential for damage in the New Madrid fault area, coupled with the financial impact of Hurricane Andrew and the Northridge Earthquake on insurance companies, are being felt by my clients and all homeowners in Eastern Missouri and other states that share this fault zone.

As you are well aware, after Hurricane Andrew and the Northridge Earthquake all insurance companies, reinsurance companies, and their rating agencies began taking another look at the potential for loss that major natural disasters could have on an insurance company's ability to pay claims. Even though these specific disasters did not happen in my area, attention has been focused on the potential for any natural disasters. Most potential hurricanes from Florida to Massachusetts and earthquakes in California pale in comparison to the potential insured property damage estimates for a major New Madrid earthquake.

Thus, we have seen our market for earthquake coverage on homeowners policies dwindle at an alarming rate. This change has been less dramatic than the market problems in Florida or California, but I want to stress that the changes in our market are no less real to my clients. We have seen companies cancel their homeowners policies, invoke moratoriums on new homeowners policies with earthquake coverage, change earthquake coverage to exclude all contents of a home, and increase premiums on either the earthquake coverage or the entire homeowners premium where only the wealthy can afford to keep their current coverage, forcing homeowners to cancel their insurance.

MARKET PROBLEMS

I wish to make clear I am not here to belittle insurance companies for their actions in my state. Insurance companies have as their most sacred duty the obligation to pay their policyholders in the event they have a claim. Many companies have decided that they would not be able to pay claims of the magnitude caused by an earthquake along the New Madrid fault.

I also am not here to praise the actions of insurance companies, or should I say "inaction". I am disappointed that many of them are content to walk away from the New Madrid fault area and do nothing to help solve our market problem. Fortunately, there are a few companies that remain in our market and are working hard to pass this legislation because they feel it will enable them to continue to honor the commitment they have to pay their claims.

Let me further explain what has been happening in Missouri and other New Madrid states. First, we have seen many companies simply withdraw from the earthquake-prone area of our state. American Family, for example, canceled all the contracts of their agencies south of Cape Girardeau, Missouri. If all the insurance companies in our area and the other New Madrid fault states had done this, we would have seen an immediate crisis like the California and Florida markets experienced. Instead, our problem has not drawn national headlines, partly because it has affected large rural areas of the New Madrid fault states. Also, most insurance companies have until recently ignored the true potential that the fault poses to large cities like Memphis and St. Louis.

I will share a personal example of companies exiting our market. In 1997, my agency was visited by a major national insurance company that we represented. The regional vice president from Chicago came to see us and three other agencies representing this company in Southeast Missouri. He told each agency that his company had looked at their earthquake exposure in Southeast Missouri and there was just no way to charge enough premium for the exposure. He asked us to either take the earthquake coverage off our homeowners policies and write that coverage separately, or to move the policies to another company. I was even more astonished when he offered to pay us to move the business! My agency did decide to move our clients' policies. Not for the money, but because this same company official had told us that they would be raising their earthquake rates to a level that would not be affordable for most homeowners.

Another agency located in Southeast Missouri was confronted with a similar situation by a different company. This agency was told that their contract with that company was being terminated because of a poor loss ratio. The owner of this agency, who did not believe his agency had a poor loss ratio after personally reviewing the loss results, talked with the company representatives. The agent was told he could keep his contract, but he would have to nonrenew all his homeowners policies with that company. He was told the real reason the company was canceling his agency and others in the area was to reduce the company's earthquake exposure. This agent, who is currently the secretary/treasurer of the Missouri Association of Insurance Agents, decided he could not nonrenew his client's policies and fortunately was able to find another company to take the business.

The most widely used tactic of insurance companies to exit our homeowners insurance market has been price. By simply increasing the cost of a homeowners policy, a company can easily see their business canceled. Now, an outside observer might think the consumer, knowing of the potential for an earthquake in our area, would not like their homeowners premium to increase, but would nonetheless keep the policy because of the need for coverage. Mr. Chairman, what if your homeowners insurance cost $313 in 1996, but you received your renewal for coverage and the new premium was $765? Naturally, you would look for other coverage. That is exactly what many of my clients and the clients of independent and direct-writer agents have been doing (and will continue to do) as this legislation is debated. The companies that dramatically increased their rates did not have to cancel any policies or withdraw from our area. The price increase accomplished this de facto.

Again, allow me to share with you an example of how my agency handled this tactic. We represented a small regional insurance company called Silvey Companies. That company was owned by General Accident. Silvey was represented by at least one independent agency in most towns in Southeast Missouri and Northeast Arkansas and offered homeowners insurance with earthquake coverage at reasonable rates. In 1997, General Accident decided to absorb the processing of Silvey's business into their existing branch offices. General Accident had only a handful of agents in our area mainly because they did not write earthquake insurance on their homeowners policies. With the absorption of Silvey's business, General Accident did not cancel the Silvey homeowners policies. Instead they simply raised the homeowner premiums on all the renewals over 100%. What was the result? The only homeowners who kept their Silvey homeowners policies were those who had no other choice because they lived in a rural area or had previous losses and another company would not write their insurance.

Recently, the Missouri Department of Insurance (MDI) has been monitoring the cost of earthquake insurance for homeowners and the percentage of homeowners who have this coverage. When they released their first data in December 1996 the headline of their press release read: "Statewide earthquake insurance market relatively stable". This study was based on data from 1993-1995. In August 1997, after analyzing data from 1996, the Department issued a press release with the following headline: "Earthquake insurance rates up sharply in Bootheel; coverage there falls off."

Even though I totally agree with MDI's latest assessment that rates are up sharply and more and more homeowners are deciding not to buy coverage, I would suggest that the Missouri Department of Insurance data does not take into account the many companies that have increased not only their earthquake rates, but also increased their homeowners rate to get out of the market totally. Unfortunately, the Department's data does not include the number of homeowners who have had to change companies for this reason. Also, not included in the Department's data are the number of companies that have exited our market, like the company in my agency that asked us to move the business or the company that terminated agents for high losses when in fact the true reason was to reduce their earthquake exposure.

A third manner in which insurance companies have handled their earthquake exposure in our area is by increasing deductibles and/or limiting coverage to just the home itself and providing no coverage for outbuildings and only $10,000 coverage for personal property. Those familiar with the earthquake situation in California have faced this same situation. Many insurance companies have seen this as a partial solution to their problem with natural disasters. I just wonder where these homeowners are going to get the money to pay for their personal property or to manage a 25 percent deductible. This is no solution for the average American, but rather a prayer that somehow it will cost 25 percent less to rebuild their home, or that when their home falls to the ground, their furniture, clothes, and other personal property will miraculously emerge unscathed.

RESTRICTING MARKETS

The final manner in which companies are dealing with a potential mega-disaster from the New Madrid fault is by simply not appointing any agents in my area.

In December 1996, with many companies restricting coverage and knowing that we faced the possibility of our present companies pulling out of the market or increasing their rates to unaffordable levels, my agency contacted over 20 companies to see if we could find a company willing to come to our area and write homeowners policies. Only one company would seriously talk with us. We offered these companies over $500,000 of profitable business and to write all lines of insurance for their company. We heard many excuses why the companies would not appoint our agency, but a few were honest enough to tell us that their company was just not interested in writing any earthquake coverage in Southeast Missouri. A similar search for companies has been repeated by almost every agency in my area. One large agency even offered to give a company $1 million in profitable business, but could not find one willing to give them an appointment. The one company that my agency did convince to come into our agency was willing to do this because they have no other agents in Southeast Missouri and do not plan on appointing anymore at this time.

Still, we do have markets available in Eastern Missouri. But how long can the few remaining companies keep writing more business, as other companies use the tactics I described earlier to eliminate their homeowners policies? State Farm has over 25 percent of the homeowners market in Missouri and has as its official policy for our area to maintain their current level of coverage. I fear that will we see more and more homeowners unable to purchase earthquake coverage.

DIMINISHING EQ COVERAGE

In analyzing their premium data, the Missouri Department of Insurance noted in their last press release that coverage was falling off in our area. Why are fewer homeowners purchasing earthquake coverage? Price is the answer. Several years ago the earthquake premium on an average home in my agency was between $30 to $70. Now the average premium for earthquake coverage is between $100 to $300. This is in addition to the basic premium increases that many companies have instituted on homeowners policies. Before this crisis hit our area I was proud to say that approximately 90 percent of my homeowners clients had earthquake coverage. Now this percentage

nas declined to roughly 70 percent, and with pending rate increases for earthquake coverage in Missouri, I fear it will fall even further.

The cost of earthquake coverage and limited availability is causing many homeowners in Missouri, Arkansas, Tennessee, Illinois and Kentucky to drop their earthquake coverage. They are being forced to abdicate their individual financial responsibility to provide insurance protection for their home. Instead, they are relying on the hope that when we have an earthquake it will be large enough to qualify them for federal disaster assistance. So I would tell you that you simply have a choice of helping restore these homeowners' ability to exercise their individual financial responsibility by enacting natural disaster legislation that will allow our insurance market to function, or wait to appropriate federal disaster assistance to an ever-growing number of citizens in my area.

I find the abdication of individual responsibility to be one of the greatest threats our country faces and that is why I believe H.R. 219 must pass and why I am working to establish a mechanism in Missouri to help our homeowners.

I have had the privilege of serving as an officer of the Missouri Association of Insurance Agents and last year was the association's president. As such, I heard the concerns of agents in Southeast Missouri and surrounding states about abandoned markets, moratoriums on new earthquake business, demands to reduce their earthquake exposures, and clients not being able to afford earthquake coverage. I also have heard from many direct writers from various companies stating that they are having similar problems. Also, during that time my late Congressman Bill Emerson had sponsored legislation that I hoped would help us with our market problem. Unfortunately, we lost a great spokesman for our cause when Bill passed away.

MISSOURI EQ TASK FORCE

Out of this tragedy for my district two positive events occurred. First Congresswoman Jo Ann Emerson was elected and continues to lead Missouri's fight toward the enactment of meaningful disaster legislation. The second item was that as president of MAIA, I decided to form a MAIA task force to look into the earthquake coverage availability problem and see what our state association could do to help since it was not clear if we would receive any assistance from the federal government. In the summer of 1997, our group of agents, two insurance company representatives, and a representative from MDI met to discuss the issue. We soon realized this was a major problem for our agents and most importantly for our clients and we needed to get everyone in the insurance industry in Missouri involved in a possible solution.

I invited the major writers of homeowners insurance in our state along with representatives from our state insurance trade organizations and the MDI to form a Missouri Earthquake Task Force. Attending the meetings have been representatives from State Farm, Shield of Shelter, American Family, Safeco/American States, Missouri Farm Bureau, Missouri Insurance Coalition, National Association of Independent Insurers, Columbia Mutual, Cameron Mutual, American Insurance Association, Employers Reinsurance Corp., E.W. Blanche Company, and Allstate Insurance.

My only agenda for this task force was do to something to alleviate the problem of restricting earthquake coverage markets in Missouri. At that time I did not know what direction it would take. I was aware of the California Earthquake Authority (CEA) and thought that we should look at the application of this plan to Missouri.

We invited a reinsurance intermediary and consulting group called PARAGON to meet with a technical working group of our task force. PARAGON analyzed the feasibility of using the CEA and the Florida Hurricane Catastrophe Fund (FHCF) approach in our market and recommended that the FHCF approach seemed to be the best solution. PARAGON then presented their same analysis of the CEA and FHCF to our entire task force at our last meeting in January. The majority of the task force agreed that some form of the FHCF seemed the best solution for Missouri.

We have a task force meeting scheduled for next month to start the process of reviewing and adjusting the NCOIL model legislation for natural disaster legislation to fit a Missouri approach. Our plan is to have this legislation ready for introduction, hearings, and hopefully passage in the next session of the Missouri General Assembly.

Is the entire insurance industry in Missouri 100 percent behind what we are attempting? Of course not. But I will tell you the companies that are dominant writers of homeowners insurance are helping us with this process. As it is with natural disaster legislation on the federal level, the trade groups and insurance companies that are opposed tend to be those that feel this approach will give an advantage to another insurance company or group over them. In Missouri, our plan is to develop a program that will involve <u>every</u> insurance company that writes earthquake coverage on homeowners insurance. The only advantage given to anyone will be to the homeowners of Southeast Missouri. They will be the true winners!

<u>H.R. 219 SOLUTION NEEDED</u>

We believe the Missouri Earthquake Catastrophe Fund will go along way to solving our problems, but for a total resolution of our crisis the Missouri fund will need the ability to purchase additional reinsurance, which would be provided by the Homeowners Insurance Availability Act (H.R. 219). The New Madrid fault poses too large of an exposure for Missouri to tackle by itself. That is the threat these giant natural disasters have for any individual state in the U.S. Even California and Florida—with their vast financial resources—need the assistance of the federal government to solve this availability and affordability problem.

The question that begs to be asked is why the federal government should help Missouri with its earthquake problem. The answer is that we are not looking for a free lunch or a hand-out. We are asking for help to solve the problem ourselves. It just will take time for us to raise the capital to wholly finance our fund and in the meantime we want to pay the federal government for the promise of reinsurance should an 8.0 earthquake strike the New Madrid fault.

I am here to ask your help in making sure that not only will the homeowners of Missouri be helped, but that all American homeowners will be the true winners of your debate on natural disaster legislation. We need to allow people and their respective states the opportunity to be proactive in helping themselves prepare financially for a natural disaster where the private market has failed. In doing so, Congress would be reaffirming that our government and society place the utmost value on personal individual responsibility.

As an Eagle Scout I always have remembered the Boy Scout motto: "Be Prepared". Mega-natural disasters are going to happen. Let us be prepared financially to restore the homes that are lost as a result of these events.

I thank the Chairman and members of the Committee for their time and would welcome any questions you may have.

UNITED HOMEOWNERS ASSOCIATION®

STATEMENT
OF
JORDAN CLARK

PRESIDENT
UNITED HOMEOWNERS ASSOCIATION

SUBMITTED TO THE
U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

CONCERNING

H.R. 219
THE "HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1997"

APRIL 23, 1998

655 15th Street, N.W., Suite 460, Washington, DC 20005

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Mr. Chairman and Members of the Committee, H.R. 219, the "Homeowners Insurance Availability Act of 1997" is another step forward in addressing the loss of life and property and the social and economic problems brought about by natural disasters, not the least of which are the escalating insurance problems faced by millions of Americans and thousands of communities across the country.

The United Homeowners Association (UHA) is a nationwide non-profit, consumer organization which in promoting and preserving home ownership, represents the interests of the nations 65 million homeowners.

As individuals and as a nation, our homes represent our greatest economic and social investment. For the millions of Americans whose homes are not insured or are underinsured, that investment can be wiped out in minutes by natural disasters.

Unfortunately, disaster victims are not limited to the disaster area. Since homeowners provide 90% of the federal income tax base, homeowners across the country end up paying for the federal response which over the last few years has been an a whopping $40 billion in federal emergency funding alone. In short, the 65 million homeowners as taxpayers and potential victims have the most to lose if we continue to ignore the disaster insurance problems spreading across the country.

Having established a public record over the past seven years on the necessity of federal natural disaster legislation, I will limit my remarks to a reiteration as to why legislation is needed and then address specific concerns with and recommendations for HR.219.

Even the most critical voice of the legislation would have a difficult time denying that there is a growing homeowners insurance problem in many of our most populated states. Because of the continued lack of affordable insurance, over 70% of California households are still not insured for earthquakes. In Florida the insurance problem is so great that the State of Florida is the second largest insurer in that state.

Texans living on the gulf coast and New Yorkers on Long Island have witnessed the egress of insurance companies, an increase in premiums, a decrease in coverage and non renewal of policies. Hurricanes, earthquakes, floods, tornadoes, wild fires, hail, winter storms, mud slides, and drought have provided residents of all states the opportunity to become disaster victims. Unfortunately, the experts tell us that more and greater disasters are on the way.

The fact is that extraordinary losses and the potential of more to come have caused insurers to stop insuring or to limit their coverage in many states. Right or wrong, the trend will continue as more disasters hit, leaving homeowners and their communities at the mercy of mother nature.

As stated, all of us, no matter where we live pay for disasters. We do not take issue with coming to the aid of disaster victims or that the federal and state response is anything but correct. But, we feel strongly that if homeowners, renters and small businesses had affordable and adequate insurance and responsive building codes were established and enforced, the federal, state and local governments' (taxpayers) bills would be reduced by tens of billions of dollars.

To those who oppose federal intervention in the disaster insurance crisis, I respectfully point out that the federal government which spends billions on disaster relief every year has been and will continue to be the insurer of last resort until we find a better and more comprehensive solution to disaster preparedness, mitigation, insurance and response.

Realizing that H.R.219 is limited in its scope and application, it is at least a positive indication that the Committee and Congress is willing to tackle the issue. However, although well intended, the ability of H.R. 219 to bring affordable and adequate insurance back into the market place is questionable at best for the simple reason that the state disaster insurance programs which it backstops are ineffective, seriously under funded or both.

For example, despite the creation of the California Earthquake Authority (CEA), over 70% of California homes are still not insured for earthquakes. With a 15% deductible and limited coverage the CEA is out of reach for most homeowners. The failure of the CEA to provide reachable earthquake insurance should come as no surprise since the CEA's purpose was not to provide earthquake insurance, but to allow the insurance industry back into the homeowners insurance market. Since the CEA has failed in its mission of providing affordable and adequate earthquake insurance to Californians, H.R. 219 no matter how well intended will have little if any effect on the availability of earthquake insurance in California.

The situation in Florida may be worse since the state fund would collapse if a major hurricane such as Andrew struck the coast line. Will federal reinsurance of the Florida program as provided in H.R. 219 solve the funding problem? Since the state fund is severely under funded, affording reinsurance may be out of the question. If purchased , one event in Florida could place severe financial strain on the federal backstop even with borrowing authority.

In essence, HR 219 might work if there were viable state programs in place providing affordable, adequate and dependable disaster insurance. In the three states with programs, that is not the case. Moreover, other states with disaster insurance problems are in no rush to create such programs. Since H.R. 219 currently effects just three states and would have little effect on solving the disaster insurance problems in those states, we hope that the Committee will continue its efforts at finding a better solution or solutions to the disaster insurance problem faced by millions of homeowners and all taxpayers.

We realize that Section 4 of H.R. 219 does provide for "State Auction Programs" apparently for all states, even those who do not have state plans. Whether states would or could take advantage of the legislation is another matter.

In the event H.R. 219 goes to markup by the full committee, we recommend that Section 5 be amended to include "apartment buildings". Over 30% of Americans live in apartments, in states such as California that percentage is over 40%. The rebuilding and repair of apartment buildings after disaster strikes is extremely important especially to moderate and low income families and individuals whose choices are limited. It is also important to homeowners since many mixed use neighborhoods exist. If apartments are not repaired or replaced, the entire neighborhood suffers as well as the former tenants.

In closing, in so far as H.R.219 contributes to an eventual solution it is a step in the right direction in recognizing a federal role in the disaster insurance problem facing millions of homeowners in many states.

We would be remiss if we did not recognize the work and dedication of Representative Lazio and the Committee in keeping the issue before Congress and the Administration and trying to solve a complex problem with many diverse and powerful stake holders.

We look forward to working with the Committee and its dedicated staff in perfecting H.R. 219 and offering viable alternatives in our never ending quest to make sure that our homes, communities and lives are protected as well as possible from the ravishes of natural disasters.

Thank you.

STATEMENT OF THE ALLIANCE OF AMERICAN INSURERS

The Alliance of American Insurers is a national trade association representing more than 270 property and casualty insurance companies. Alliance membership is diverse, including major multi-line writers doing business in every state, as well as regional writers and niche companies. Alliance members offer a broad range of personal and commercial insurance products. We offer the following comments regarding H.R. 219, the Homeowners' Insurance Availability Act of 1997 for consideration by the committee and request that our statement be entered into the committee's hearing record.

Over the last decade or more, the Alliance has been involved in the discussions of proposals that have been suggested to deal with the catastrophe issue. While the Alliance supports government involvement in areas such as flood insurance, we believe that H.R. 219 would encourage greater government involvement than is warranted at this time.

H.R. 219 as currently drafted requires the Treasury to offer single-year Federal reinsurance contracts to eligible state insurance programs to cover residential losses in the event of a natural disaster. The Federal reinsurance backstop of H.R. 219 becomes applicable once a participating state's capacity to cover insured losses is exceeded. This level would vary for different states, but would generally apply to events that have a chance of occurring of less than once every 100 years.

Several states have developed property insurance and reinsurance pools to handle the results of catastrophic events such as hurricanes and earthquakes. Examples of these plans are the California Earthquake Authority and the Florida Hurricane Catastrophe Fund. Hawaii also has a pool to reinsure hurricane losses. Other states have pooling arrangements that could be reorganized to qualify as state pools as defined in H.R. 219. Still other states may be encouraged to form pools in order to potentially obtain federal reinsurance funds as contemplated in this proposal. We believe as presently drafted, H.R. 219 would encourage formation of state insurance plans.

Both the growth of these state plans and the federal response to reinsure them is of great concern to the Alliance. Except in rare instances of market failure, our member companies believe that insurance issues are best left to private market solutions. Therefore, the Alliance opposes the present form of H.R. 219 and the underlying premise that state pools need federal reinsurance. The Alliance believes that state pools perpetuate a regulatory philosophy among some state insurance regulators that result in suppression of rates and

mandate participation in writing insurance using inadequate rates. In our view this results in substantial market dysfunction.

A principal reason for some of the problems in some costal areas is inadequate land use and continued construction development. Not only does construction continue of homes and businesses on beach fronts and fault lines, but not enough has been done to require that these properties are built to withstand even moderate wind storms or ground shaking. The same problems are faced by the federal flood program where major sections of towns are allowed to rebuild following a flood only to be faced with the virtual certainty that another flood will subsequently occur.

This results in an endless cycle, wherein both federal and state governments spend huge taxpayer money in disaster relief and to rebuild infrastructure in flood, hurricane, and earthquake zones as well as furnish low cost loans or outright grants to people who had declined to purchase available insurance. We believe that the wisdom of these policy decisions to spend taxpayer funds for disaster relief should be addressed prior to passing any legislation on the federal level.

The Alliance believes that state pools and a federal reinsurance program to insure those pools, as proposed by H.R. 219, will place a continued burden on insurance companies to provide coverage for properties at taxpayer and insurance policyholder subsidized rates. The mitigation issue, as pointed out above, is what the Alliance believes to be the central issue to resolving this national problem of coping with natural disasters. H.R. 219 as presently drafted fails to provide adequate funding to ensure some level of property mitigation. We encourage Congress to utilize mitigation as an important and vital tool in this debate to address disaster insurance.

As stated above, the Alliance opposes H.R. 219 because it would continue to perpetuate the cycle of insurance rate suppression, rate subsidization, and overbuilding. The Alliance would be pleased to participate in any discussion that would seek to deal with the core issues of establishing an enforceable building code and a national mitigation policy.

The Alliance thanks Chairman Leach for holding this hearing and encourages the committee to conduct oversight hearings into the various issues prior to moving ahead on H.R. 219. We look forward to working with the committee and to provide whatever additional information that is needed.

AMERICAN ACADEMY *of* ACTUARIES

Banking and Financial Services Committee
U.S. House of Representatives

Hearing on
Homeowners' Insurance Regulation

Testimony Presented
By

Paul O'Connell, FCAS, MAAA
Chairperson, Catastrophe Working Group
American Academy of Actuaries

April 23, 1998

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, regulators and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance

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The American Academy of Actuaries appreciates the opportunity to provide comments to the House Banking Committee on the prospect of federal reinsurance for homeowners' insurance coverage in catastrophe-prone areas. The Academy hopes that you find these comments helpful as you review H.R. 219, the Homeowners' Insurance Availability Act of 1997. The actuarial profession is uniquely qualified to examine the issues relating to insurance and reinsurance of natural disasters because of actuaries' extensive practical experience in pricing natural disaster coverage for the private marketplace.

The House Banking Committee has asked the Academy to comment on the actuarial provisions contained in H.R. 219. Specifically, this testimony discusses the need for a federal program, the attachment point for federal coverage, the determination of risk load, the federal limit of liability and eligible losses.

The Need for a Federal Program

As stated in H.R. 219, among the findings of Congress are that "the lack of sufficient insurance capacity threatens to increase the number of uninsured homeowners . . . " and " . . . while State insurance programs may be adequate to cover losses from most natural disasters, a small percentage of events are likely to exceed the financial capacity of these programs and the local insurance market." Therefore, " . . . Federal reinsurance for State disaster insurance programs will improve the effectiveness of such state initiatives and increase the likelihood that homeowners' insurance claims will be fully paid in the event of a large natural catastrophe . . . "

To summarize, the authors of H.R. 219 believe that a federal reinsurance program is needed because the private insurance marketplace does not have sufficient capacity to ensure payment of losses to residential property in the event of a truly severe natural disaster such as a major earthquake or hurricane. Although this may be currently true of the traditional insurance and reinsurance market; it should be noted that there have been attempts, (e.g., Chicago Board of Trade options, catastrophe exchanges, "Act of God" Bonds), with varying degrees of success, to move beyond the traditional market and to tap the capital markets for capacity for catastrophic perils. This notion is discussed in H.R. 219, which requests that the Secretary of the Treasury report to Congress on " . . . the extent of the market for resale of reinsurance contracts under this Act in the capital markets."

One of the roles of a federal reinsurance program could be to determine in advance whether there is sufficient capacity in the private markets– both insurance and capital. This will help the federal government achieve the stated desire for the program to " . . . not interfere in the private markets." Such determination would have to be performed annually and would have to explore all available options including newly developing and emerging products or markets. The federal government would not want to stifle the development of new derivatives or other securities that may help resolve such capacity shortages.

Attachment Point for Federal Coverage

H.R. 219 proposes to provide $25 billion of excess coverage to state insurance programs and state reinsurance programs. Each state program has a limited ability to cover residential property losses

for catastrophic perils, which is defined as the state claims paying capacity. The federal government does not want to interfere with the private market; therefore, the attachment point needs to balance the state capacity with the private marketplace's ability and desire to provide coverage.

H.R. 219 provides for a minimum attachment point for existing state programs to be the greater of:

(a) $2 billion; or

(b) the current claims paying capacity of the eligible state program, as of the date of enactment of the Act.

For new programs, those commencing on or after January 1, 1998, an additional test is included such that the minimum attachment point is the greater of (a) or (b) above or:

(c) "an amount, determined by the Secretary in consultation with the National Commission on Catastrophe Risks and Insurance Loss Costs established under section 10 of the Act, which is sufficient to cover eligible losses in the State for all events having a likelihood of occurrence in any 12-month period that is greater than one percent."

Because a tiered test is applied, it is possible that the federal attachment point will be greater than the state's claims-paying capacity, leaving a gap or loss corridor. Such a loss corridor can have positive effects, such as providing the state with incentive to aggressively pursue private market coverage and to be vigilant on claims settlements. However, if there is no private capacity available what are the consequences? Will the state treasury have to fund the losses? Will claim payments to the insureds be prorated?

In a time of a major catastrophe, a state's resources will be severely stretched. Tax revenues will be reduced and there will be damage to infrastructure and government buildings that may be self-insured. The federal program and state funds would cover only residential property losses. However, there will also be significant commercial insurance losses. Before one can propose a formula that may lead to a loss corridor between the state and federal programs, the issue of funding for this corridor needs to be addressed.

In the federal attachment formula, a $2 billion threshold is used as one of the tests. This threshold will either prove to be irrelevant (i.e., all states will easily satisfy the test or it will prove to be difficult for all to reach) or it will create uneven access to the federal program favoring large states and/or states with significant exposure to catastrophes. Congress should consider whether such uneven access is the intent of this legislation.

Determination of Risk Load

There are a number of considerations that need to be explored when determining an appropriate risk load. In the Act, the definition of the risk-based price seems to infer that it is intended to be simply the expected costs or expected losses. Therefore, an additional risk load will be appropriate. The magnitude of the risk load should depend upon a number of considerations.

Assuming that the risk-based price is in fact an estimate of the expected losses under the program without an additional risk load, the following need to be considered when determining the risk load:

1. **Repayment by state program** -- Section (7) Paragraph (6) explains the terms of repayment should a state program collect from the federal government. It infers that federal government will ultimately be fully reimbursed for coverage provided. If this is true, the only risk borne by the federal government under the program is credit risk, or the risk that the state will be unable to fully repay. Timing risk is eliminated since the state program requires repayment of interest costs.

2. **Codifying a risk load** -- The legislation states that the risk load shall be not less than the risk-based price. We recommend against stating a risk load or even a minimum load in the legislation. Any number stated will be used as a benchmark by the private insurance or reinsurance industry. In addition, while a minimum may be appropriate today, it is possible that over time the appropriateness of that minimum may change, and in the future that minimum load may prove to be excessive.

3. **Risk load based on specific state circumstances** -- A risk load needs to reflect a variety of circumstance specific variables, in addition to the repayment terms noted in item 1 above. These variables include the probability of catastrophic losses, the federal attachment point, and the concentration of exposures in a given area. Because these variables will change over time, it is essential to review the risk load on a regular basis.

4. Repayment to State Programs -- The Act does not discuss what happens to the accumulated premiums in the event that no eligible event occurs. The potential for return of premiums and/or investment income to the states needs to be factored into the risk load calculation.

5. Actual Market Pricing -- Real markets do not always behave as theory predicts; therefore it is not sufficient to rely solely on a theoretical approach when calculating a risk margin. Consideration needs to be given to the then-current competitive environment, as well as the cost of capital for the private market. A theoretically sound price that is below the market demands will interfere with that market.

It is our recommendation that the National Commission advise the Secretary on both the risk-based price and the risk load and that each be based on the state programs' specific variables. The Secretary should also look to the private market as a guide for an appropriate risk load.

Federal Limit of Liability

The Act sets a maximum limit of $25 billion on annual payments under all contracts for the federal program. Since coverage of up to $25 billion will be offered to each qualified state program, the total coverage in force may be many times this maximum limit. The Act does not specify how this maximum limit would be shared in the case of multiple eligible events, or in the case of a single event that affects more than one state program. Of particular concern is the timing differences in the

payment of losses. Should an eligible event occur early in the year, would the federal government hold back funds otherwise payable in anticipation of additional eligible events later in that year? For example, if a January earthquake were to occur, the federal program would not know what percentage of the coverage limit would be available to the affected state program until the year ended. Therefore, payments to the state program and payments to the homeowners would likely be delayed.

The language concerning the time period of coverage also needs to be refined. In the Act, it states "... the maximum amount paid for all events in any single year by the Secretary pursuant to claims under all contracts for reinsurance under this Act shall not exceed $ 25 billion". This could be read as an annual payment limit, but not a coverage limit. For example, if a single event or series of events occur in a twelve-month period with damages equal to $50 billion but payments extend over a two-year period of time, would the federal program pay up to $25 billion each year? Or is the intent to limit the payment to $25 billion for all events ***occurring*** in a single year regardless of when the payments are made?

We have assumed that all federal reinsurance contracts will run concurrently, therefore have a common inception date. If contract effective dates are staggered, then the issue of aggregate payment limits and proration of claim payments will be more difficult to manage.

Eligible Losses

In the definition of eligible losses included in the Act, there is a time limit noted as "... claims for property losses covered by qualified lines that are paid within the 3-year period beginning upon the event ... ". While we understand the desire to put a time limit in place for payment of losses, it should be noted that all loss payments for the 1994 Northridge earthquake were not paid within in a three-year period. An even more severe event could easily result in loss payments extending over a period of time well in excess of three years.

Other Considerations

The Act places a higher standard on new programs than on existing state programs. Not only is there a third test in the determination of the federal attachment point, but new programs are required to charge premiums rates that, "... at a minimum, are sufficient to cover the full actuarial costs of such coverage ... ". No such standard is present in the Act for existing state programs.

The Act requires repayment from a state program in the event that program receives claims payment from the federal program. However, the Act also gives the State insurance commissioner the authority to terminate a state program if the commissioner believes that the program is no longer needed. How will the federal program be reimbursed if the State commissioner ends the state program?

Congress should consider the interrelationship (if any) between the federal reinsurance program established in this Act and federal disaster relief programs. In particular, should the reinsurance program established in the Act increase the availability of homeowners' coverage in catastrophe prone areas, then there may be a savings to the federal government in the form of reduced disaster-relief outlays. On the other hand, if disaster relief outlays continue to be made available to states that do not establish their own reinsurance programs, then the incentive to establish state programs that address this issue may be severely diminished.

The Academy supports the inclusion of professional actuaries on the National Commission on Catastrophe Risks and Insurance Loss Costs. The Academy would be available to work with the Secretary to identify actuaries who are qualified to serve on this Commission.

Conclusion

The stated goal of the Homeowners Availability Act of 1997 is to provide protection to state insurance programs to ensure solvency in the event of a catastrophic event, while at the same time, not interfering in the private marketplace. We have identified sections of the current Act where we believe that the Academy could provide expert analysis and support to Congress. The American Academy of Actuaries is available to provide assistance to Congress on this legislation or any subsequent Acts that are proposed on this topic.

STATEMENT FOR THE RECORD
CALIFORNIA CREDIT UNION LEAGUE
HOUSE BANKING COMMITTEE HEARING
HR 219 - THE HOMEOWNERS INSURANCE AVAILABILITY ACT OF 1997
APRIL 23, 1998

The California Credit Union League represents more than eight million credit union members and more than 725 credit unions in the states of California and Nevada. We appreciate this opportunity to submit comments in support of legislation designed to establish a federal reinsurance program to backstop the efforts of the private casualty and property insurance industry and provide adequate disaster insurance coverage for the millions of homeowners in our region of the nation. The Congress has three major bills before it to address this issue: HR 219 with forty cosponsors including eight members of Congress from California and Nevada; HR 230 (six cosponsors from California) and HR 579. These legislative initiatives are all an excellent start in designing a comprehensive solution to the problem that homeowners across the nation face as a result of catastrophic earthquakes, hurricanes or tsunamis. We are mindful that the Treasury Department has not yet endorsed any of these bills but we strongly urge the House Banking Committee and the many cosponsors of these measures to work together speedily to devise a comprehensive package that the Congress and the Administration will support and enact promptly.

THE EXISTING DISASTER INSURANCE SITUATION

Risk management experts have noted that the risk of natural disasters has increased significantly in recent years. For instance insurance analysts contend that:

- The 1926 hurricane that hit Miami in 1926 would result in property losses of more than $70 billion today.

- The probable maximum loss from a California quake today is more than $50 billion.

- A Midwest quake along the "New Madrid fault line could result in losses of close to $100 billion.

- Hurricane Andrew losses totaled more than $33 billion, with approximately half of that insured.

One recent study by an insurance research group estimated that approximately one-third of property insurers could be bankrupted in the future by a $50 billion catastrophe (Insurance Services Office-1996).

In short, this is a national problem which will require a national approach if we intend to protect homeowners across the nation from a future financial disaster.

THE CALIFORNIA DISASTER INSURANCE PROBLEM

The California Earthquake Authority (CEA) was established by the state government after the January 1994 Northridge Earthquake and began operation in December 1996, a little over a year ago. The CEA receives no public money and is funded by several sources including initial capital of $1 billion from private property insurance companies in the state, a standby assessment of $5 billion from private insurers to be drawn down after the next large earthquake, third party reinsurance of $3.5 billion and a $1 billion line of credit.

However, to limit losses and payments to California homeowners after the next large earthquake, the CEA program contains the following provisions

* Dramatically reduced coverage of property losses. The CEA policy carries a 15% deductible and has no coverage for outbuildings such as garages and other structures not attached to the house.

* A $5000 limit on personal property coverage.

* Premiums that are two to three times higher than in other geographic areas.

* No backup coverage if losses from the next earthquake exceed the financial resources of the CEA.

Effectively, the deductible or homeowners' self insurance can total 20- 25% of the costs of repairing or replacing a home damaged by the next large natural disaster. Moreover "in the event that an earthquake or a series of earthquakes exceeds the available resources of the Authority, policyholders claims will not be paid in full. Instead of taking that risk, many policyholders will make the economic decision to not purchase a CEA policy, knowing, or at least hoping, that the federal government will be there with resources after an earthquake" (testimony of the CEA before the House Banking Committee-June 24, 1997). In short, the current disaster insurance situation in California, and many other states is a disaster waiting to happen - with millions of homeowners **and lenders (including credit unions)** gambling that the federal government will provide massive disaster relief assistance after the next natural disaster catastrophe.

The California Credit Union League believes it makes more sense to take preventive actions now, establishing a federal natural disaster reinsurance program as soon as possible, to reduce the need for massive federal natural disaster expenditures later.

IMPACT ON MORTGAGE BORROWERS AND MORTGAGE LENDERS

Insurance companies have several strategies for reducing their financial exposure to disaster risks. "Redline" or simply refuse to renew earthquake coverage in higher risk areas. "Ration" insurance coverage by not selling policies with disaster coverage to new customers or homeowners. Or, if the state insurance regulators will not permit rationing, establish large deductibles to minimize claims and to shift the disaster financial risk to homeowners and mortgage lenders. And finally, charge premiums that are so large that customers will not voluntarily buy that coverage

From a risk minimization perspective this is rational behavior by a private insurer attempting to reduce the risk of extraordinary payouts. However, it is poor public policy and leaves homeowners, particularly young, and low-to moderate income home buyers with high loan to value mortgages, with the risk of catastrophic losses. California and Nevada already have high personal bankruptcy rates; those bankruptcy rates would clearly soar unless adequate homeowners insurance coverage becomes available soon.

As for mortgage lenders **(including credit unions)** in high risk areas, they face the same choices as the insurance carriers. However CRA and similar lending requirements prevent many of them from refusing to lend in many higher risk areas. They may either accept the risk of disaster losses or be forced to charge higher mortgage interest rates for assuming the risks of covering disaster losses.

These are not satisfactory public policy solutions to the disaster insurance problem. Merely shifting the risks backwards to the home borrower or forward to the mortgage lender is a form of "financial hot potato". It does not resolve the fundamental problem.

GUIDELINES FOR A FEDERAL REINSURANCE PROGRAM

Homeowners (many are credit union members) may have very different objectives than those of the insurance industry in designing responses to the disaster insurance dilemma.

The California Credit Union League would strongly support a federal reinsurance program that meets the following tests and protects the homeowner and particularly the first-time home buyer with a high loan-to value mortgage.

* The program should ensure that private insurers will offer comprehensive coverage against disaster risks; with low or nominal deductibles. The policies should be modeled after automobile collision coverage where close to 100% percent coverage is available.

* The disaster insurance risks have to be spread over a large enough population so that the insurance premiums will be modest and reasonable.

* Through the availability of adequate coverage, protect mortgage lenders against assuming disaster risks to ensure that mortgage financing will continue to be available to all eligible borrowers. A well-structured federal disaster insurance program would prevent subtle forms of economic "redlining".

* Such a program would protect the federal deposit insurance funds from becoming the "de facto" disaster insurer - accepting the risks inherent in a mortgage portfolio which does not have adequate disaster insurance coverage.

* And finally, a well-structured federal disaster insurance program would obviate the need for vastly increased post-disaster federal expenditures in the future - expenditures that are likely to total in the tens of billions of dollars. It would seem reasonable for the federal government to "pay now"- accept some reinsurance risks, rather than "paying later" through massive emergency appropriations after the next natural disaster catastrophe.

NATIONAL TAXPAYERS UNION

Statement of

David L. Keating
Senior Counselor
National Taxpayers Union

on
HR 219
submitted to the

Committee on Banking and Financial Services
U.S. House of Representatives

April 23, 1998

The 300,000-member National Taxpayers Union strongly opposes HR 219 because if this bill becomes law, automatic and massive taxpayer losses of up to $25 billion (and more in the future) could result from a natural disaster. We fear that support for this legislation among special interests outside Congress is primarily being driven by a small number of insurance companies that have mismanaged their underwriting. In its current form, HR 219 proposes a massive increase in corporate welfare.

HR 219 creates many disincentives for the states to properly regulate insurance rates in high-hazard areas and the insurance industry to properly assume risks in a disciplined fashion at the right price. It proposes nothing to encourage insurance companies to manage their disaster insurance risks well, and if passed would result in rewarding companies that have been the least disciplined and the least professional in their accumulation of risk.

The bill would establish a new federal Disaster Reinsurance Fund and associated bureaucracy in order to provide insurance for state insurance programs. Unfortunately, the legislation would encourage state insurance funds to choose federal insurance rather than private insurers and reinsurers, putting American taxpayers at great risk for massive losses. The legislation essentially makes the federal government liable to pay the losses for an insurance scheme over which it has no significant regulatory control! This bill effectively creates a federal entitlement to a loss payment to homeowners after a significant disaster.

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Even if the state programs were subject to extensive federal regulation, that is no assurance that expensive losses could be avoided. Much of the expense of bank and savings and loan bailouts of the 1980s occurred even though these industries were under extensive federal regulation.

While there is always substantial danger of political influence in the rate-setting process, these dangers are particularly acute for the rates that may be charged for the federal insurance to the state insurance pools. State governors and legislators have special access to members of Congress and the Secretary of Treasury. This access and influence is in addition to the other pressures that would normally exist. Therefore, it is quite likely that premiums for reinsurance pools will be set at an artificially low level, especially since the electoral-vote rich states of California and Florida would likely be subsidized if this legislation becomes law.

In conclusion, we strongly urge the Committee to remember that even the best-intentioned programs can have budget-busting consequences. While legislation may be needed to reduce the impact of natural disasters, Congress must ensure that it does not create another fiscal disaster. HR 219, as written, would virtually guarantee a fiscal disaster in the future.

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